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IN THE

United States Court of Appeals

FOR THE THIRD CIRCUIT

No. 12,255

TELESERVICE COMPANY OF WYOMING VALLEY, *Petitioner-Appellant*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF AND APPENDIX FOR PETITIONER-APPELLANT

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July 15, 1957

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Internal Revenue Code of 1954:
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Section 118 (a) 37a
Section 362 (c) 37a

Regulations:

Treasury Regulation 111 (Internal Revenue Code of 1939):

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Income Tax Regulations (Internal Revenue Code of 1954):

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APPENDIX A

Docket Entries

1955

Apr 4—Petition received and filed. Taxpayer notified. Fee paid.
Apr 5—Copy of petition served on General Counsel.
May 23—Answer filed by General Counsel.
May 23—Request for Hearing in Philadelphia filed by General Counsel.
May 27—Notice issued placing proceeding on Philadelphia calendar. Service of answer and request made.

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Mar 27—Hearing set June 18, 1956, Philadelphia, Pa.
Jun 19—Hearing had before Judge Tietjens on the merits. Stipulation of Facts with exhibits 1-A thru 5-E filed. Briefs due 8/20/56; replies 9/19/56.
Jun 25—Transcript of Hearing 6/19/56 filed.
Jul 25—Joint motion to correct transcript, embodying corrections, filed. Granted 7/26/56. Copy served 7/27/56.
Aug 17—Brief filed by petitioner. 9/20/56, served.
Aug 20—Motion to extend time to 9/19/56 to file brief filed by respondent. Granted 8/21/56. Served 8/22/56.
Sep 19—Brief filed by respondent. 9/20/56, served.
Oct 19—Reply brief filed by petitioner. 10/22/56, served.
Oct 19—Reply brief filed by respondent. 10/22/56, served.

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Jan 29—Findings of Fact and opinion filed. Tietjens J. Decision will be entered for respondent. Served 1/29/57.
Jan 29—Decision entered, Norman O. Tietjens, J. Div. 1. Served 1/29/57.
Feb 12—Petition for review by U.S. Court of Appeals, Third Circuit, filed by petitioner.
Feb 13—Proof of service filed.

Stipulation of Facts

* * * * *

5. In order to bring television signals to residents of these cities, petitioner constructed what is familiarly known as a community television antenna system; more specifically as follows: A tower was erected, located on a point sufficiently high to overcome intervening terrain, atop which was mounted a master antenna capable of receiving several different television signals; electronic and amplifying equipment was installed designed to transmit over cables the signals picked up by the master antenna; cables were laid from the master antenna to the cities involved, with a distribution cable and/or wire system ultimately terminating in open-end wires located at the residences of those desiring television service through the system. To this open-end wire or terminal, a subscriber could attach a conventional television set and thereby receive the television signals that had been picked up in the initial instance by the master antenna. Petitioner was the owner of the tower, master antenna, electronic and amplifying equipment, cable, wire, terminal receptacles and all other equipment (with the exception of the utility poles) used in the transmission of the television signals from the antenna to said terminal receptacles.

6. When a potential service area was determined, employees of petitioner first solicited possible subscribers for service prior to undertaking the installation of any facilities for making its service available to the said potential service area. Subscribers were requested to sign an application, copy of which is attached hereto and marked Exhibit 3-C. Construction of facilities for the particular area did not proceed until a sufficient number of applications had been received to indicate to petitioner that the extension would be feasible. Such determination was entirely within the discretion of its officers. Upon acceptance of an area for the extension of service, petitioner entered into

contracts with the subscribers, a form copy of which contracts is attached hereto and marked Exhibit 4-D.

* * * * *

12. During the period February 20, 1951, to January 31, 1953, petitioner took no deductions on its income tax returns for depreciation of the physical facilities of the community antenna television system.

13. The Internal Revenue Service treated the above-referred-to initial payments during the two pertinent fiscal years as gross receipts subject to income tax, and set up a depreciation item in each year with respect to petitioner's physical facilities.

Exhibit 5-E

Exhibit 5-E

TELESERVICE COMPANY OF WYOMING VALLEY

Analysis of System Construction Costs and Customer Contributions Accounts

(Balances shown are cumulative totals)

[• • •]

Year and Month	Total Construction Costs	Customer Contributions
1951		
To October 31, 1951	$ 24,138.49	None
To November 30, 1951	41,143.11	$ 7,783.34
December	56,752.39	12,371.68
1952		
January	62,880.64	27,601.98
February	71,051.26	37,913.76
March	74,165.34	43,898.88
April	81,602.10	45,913.88
May	98,059.51	53,767.88
June	108,224.93	62,291.88
July	112,938.83	71,008.53
August	114,717.40	76,156.03
September	117,286.93	88,606.33
October	121,664.20	96,733.08
November	125,838.64	102,495.07
December	129,452.09	111,612.27
1953		
January	133,501.42	116,146.77
February	131,822.82	118,544.47
March	130,565.98	119,206.47
April	131,267.03	119,816.72
May	131,701.99	120,019.47
June	133,218.37	120,222.22
July	133,723.77	120,714.41
August	134,376.34	121,066.23
September	134,581.43	121,252.73
October	135,132.06	121,602.23
November	136,413.59	121,717.73
December	137,169.16	121,891.73
1954		
January	137,118.00	122,193.48

Excerpts From Testimony and Proceedings

9 Whereupon,

Ralph Katrosh

was called as a witness on behalf of the Petitioner and, having been first duly sworn, testified as follows:

* * * * * * * * * * *

11 Q. Will you relate for the record and for the court what studies you made with respect to the development of this company, if any? A. Originally, of course Wilkes-Barre being in the screened television area, we had no television sets. In the latter part of 1950, one company had developed this community antenna system and we heard about it—that is, I heard about it through a friend, and made some investigations and found out that it was usable. However, it was necessary in the beginning to first find a signal somewhere on top of the range of mountains that surround Wilkes-Barre and Kingston. We worked for about six months until we found a suitable place. After we found a suitable area where the signal could be intercepted, I then approached Mr. Davis and Mr. Smith and told them such a thing was possible.

12 Q. Will you proceed then to indicate any other studies that you may have made, Mr. Katrosh? Did you investigate any other systems that might be operating? A. We investigated two systems. We investigated the system in Lansford that we saw physically and in operation. We investigated another system in Pottsville. That system was not in operation; it was in the process of being constructed.

Q. Roughly, Mr. Katrosh, at what time in your planning would you say that you definitely determined to go forward with the organization of a company with the view to providing television signals to the residents of Wilkes-Barre and environs? A. As well as I can recollect, January of 1951.

Q. Would you indicate now the planning made by your company with the view to financing the operations proposed? A. That was a difficult thing to decide on because our particular system was unlike those that we had investigated in that we had a dead trunk line run. By that I mean a trunk line of coaxial cables that ran for about five miles before any sizable service could be offered. That was costly, and we were not too sure that it would be a success.

Q. The cable run to which you refer was the run from your tower to the outskirts of the community to be served, I gather. A. Yes, from Wyoming Mountain to the edge of the populated areas on the fringe of the City of Wilkes-Barre.

* * * * * * * * * * *

13 Q. After these conferences, what determinations did you make, Mr. Katrosh—when I say "you," I mean your company—with a view to financing the actual building of the system? A. It was an unknown business and we had no precedent to follow. We could not find any definite information on past experiences. It would be entirely too great a risk for us to undertake that investment on a shortlived basis. At that time the licenses for
14 the U.H.F. stations as yet were not issued. However, there were indications that shortly U.H.F. station licenses would be in issue. We knew that one company in our city, Radio Broadcasting Company, would apply. Therefore, it was a great risk to invest money into this. However, there was a demand and a desire to view television in Wilkes-Barre, and we believed that we could bring it to the public, particularly after we had talked with Mr. Mallon and the contribution idea was presented to us.

Q. Is it correct to say then, and correct me if I am wrong, that as a result of your conferences you determined to proceed with the construction of the system with the idea of contributions from potential subscribers as a means of financing the actual construction of the system? A. Yes.

Q. You might state for the record at this point, Mr. Katrosh, your original position with the corporation. A. I was the general manager.

Q. Were you also a stockholder? A. A shareholder and president.

Q. At the time you proceeded with the view to implementing this plan, what considerations were involved in determining the charges that would be made with respect, first, to the monthly maintenance of the system? A. On the monthly maintenance of the system we had had in-
15 formation from the two companies that we had contacted. If I remember correctly, their charge was $3.75 or $3.50, their service charge. We believed that because we had this long trunk line, dead run, to maintain that it was proper for us to charge four dollars. We did not think it would be possible to get any more than four dollars.

Q. In your planning what was it contemplated that this four dollar monthly charge for the subscriber was designed to cover? A. It was designed to cover the maintenance of the community antenna system.

* * * * * * * * * *

16 Q. Will you explain for the record please the mechanical steps which were taken in the actual construction of the system? That need not be in detail, merely indicate the various steps taken from the very
17 first in the actual construction of the system. A. Yes. The very first, of course, was the tower and the intercepting antennas.

Q. May I inquire, had you received any contributions up to that point? A. No. Of course the main trunk line was down to the first distribution area.

Q. That was a distance of how far? A. That was about five miles. Then we erected services in a very limited area and we stopped our construction there because by that time our construction costs were about what we wanted to risk.

We believed that by stopping there and having a limited area whereby we would receive contributions, we could later on go further with the system, and that is exactly what we did.

Q. Will you explain briefly the various steps thereafter taken before extending the system further? A. Before we extended the system?

Q. Yes. A. We solicited the area to find out how many people were interested in contributing to the aid of construction of this system and also received contributions and made the service connection for them. At each time that a contribution was made, before a service was
18 available to the contributor, there was an in-advance maintenance charge made for the services he was to receive for the next thirty days.

Q. Did you have any criterion or reference point to which you related whether you would or would not extend the system, say down a particular street? A. Beyond that point, yes. Beyond that point we analyzed the mail that came in for people that were interested. We sent additional solicitors to find out if other people would be willing to contribute, determined the cost of the next extension which may supply a potential of four hundred, five hundred customers. We could estimate that cost. We didn't have any signed contracts at this particular time in this new area. We did get the reaction of the people in the area, and if that reaction amounted to at least 50 per cent of the cost of construction then we would go ahead using the money that we had obtained from the contributors previous to that.

Q. What explanation, if any, was given to a potential subscriber with respect to this contribution required? At the time an individual was approached, was this explained to him as to what this was for, the contribution? A. Yes, the contribution in aid of construction for supplying the television programs, and at the same time that it had no bearing on the services; that the service charge was an extra item.

19 Q. In making the contribution to the construction of the system, did the individual thereby become entitled to receive the television signals over the system? A. No.

Q. What was the condition precedent to the actual right to receive the signals? A. The payment in advance of the maintenance charge.

* * * * * * * * * * *

Q. Were the amounts received by way of contributions at any time applied by your company for any of the expenses normally chargeable to operation? A. No, sir.

Q. What income of the company was employed for the operating and maintenance charges involved in the business or cost in connection with the business? A. The only income we had was from the service charge.

20 Q. That is, the monthly charge? A. Monthly charge.

Q. In organizing the company, Mr. Katosh, to what did you and your associates look in the economic sense for the profits of the business? A. As mentioned before, we believed that the investment would be too great to realize a profit, and that is why the contribution idea was accepted. Whatever profit we may gain was to come from the service charges.

* * * * * * * * * * *

22 Q. During the period of your association with the company, Mr. Katosh, did it ever declare a dividend? A. No, sir.

Q. Did any of the stockholders receive any moneys, however denominated, from the corporation apart from you as the general manager? A. No, sir.

Q. Were you devoting your full time to the company? A. I devoted full time after the incorporation of the company.

Q. What was the compensation that you were to receive as the general manager? A. Seventy-five hundred a year.

Testimony of Ralph Katrosh

Q. Were you paid that sum each year during your
23 association with the company? A. No. I was paid a collective amount in January of 1953. It was the first remuneration that I had received since the incorporation of the company.

Q. You were paid in one lump sum then for your services that had accumulated to that date? A. That is correct.

* * * * * * * * * *

26 Q. Why did you find it necessary to reduce your initial residential contribution? A. We were begin-
27 ning to stop future construction. We didn't intend to continue on because of the competition from U.H.F. stations, so it was not necessary to have a building fund that was created by contributions. It was not necessary to have it, so we would probably have to spend fifty, sixty thousand dollars on it to make the next extension. However, we had as yet not received from contributions the cost of construction.

Q. This reduction in rate first occurred, I believe you testified, in January of 1953? A. January 1, 1953.

Q. At what time did the U.H.F. stations start to operate in the Wilkes-Barre area? A. I think the first one came on January 1952.

Q. Isn't it true that this reduction in the initial station in a residential area was conditioned on the increased competition used by these U.H.F. stations? A. No, sir.

Q. From the competitive standpoint, you were forced to reduce your contribution? A. We always considered that initial contribution depending on our construction. We had decided not to construct any more. As I said before, our cost of construction had not been reduced at that time.

* * * * * * * * * *

36 Q. Mr. Katrosh, I believe that you mentioned that before going into an area you would make a survey to determine the potential subscribers in that area. A. Yes.

Q. What percentage of it did you say you would require before the extension was made? A. We didn't base it on percentage of residents in the area, we based it on recouping at least 50 per cent of the cost.

37 Q. Suppose that you went into an area on the theory that you could recoup 50 per cent of the cost, you had enough subscribers and additional subscribers wanted to come into your system. What happened then? A. Naturally, we expected additional subscribers in all areas at all times.

Q. Suppose that on the theory that you were to recover 50 per cent of your cost initially and had enough to come on to make up more than 50 per cent of the remaining cost, what would happen then? A. Of course that would depend. We didn't pin it down to areas. After all, this community antenna system was as a whole and our consideration was as a whole and construction as a whole. Naturally the contributions were considered as a whole, too; they were not considered as areas. So our accounting system integrated.

Q. Suppose you had underestimated the necessary number of connections in the area. Isn't it true that in that case you would have had more money received than your actual construction cost? A. You mean for that particular area?

Q. Yes. A. We didn't base it on that. I can't tell you whether we did or not because we based it on the community antenna system as a whole.

* * * * * * * * * *

39 By Mr. Peil:

Q. What provisior did you make, if any, to assure yourself or assure the corporation that your construction costs would never go below the contributions? A. As mentioned before, reduction in the contribution. At the present time it is reduced to zero by the new company—by the new owners, it is the same company.

The Court: In other words, when you got your construction costs recouped, you intended to cut out your initial charge?

The Witness: The contributions would be entirely as they are now.

Mr. Peil: No further questions.

The Court: Suppose your company was liquidated, what would happen? Who would get the benefit, the stockholders?

The Witness: There would not be any benefit, Your Honor, because the salvage value of the equipment would be less than the cost to dismantle.

46 The Court: The only way then you get anything out of this capital contribution, as you call it, is to keep in operation?

The Witness: Keep it in operation and try to operate it: profit from the service charge.

* * * * * * * * * *

41 Whereupon,

George F. Gardner

was called as a witness on behalf of the Petitioner and, having been first duly sworn, testified as follows:

* * * * * * * * * *

47 By Mr. Peil:

Q. Do you agree that the salvage value from those fixed assets is relatively inconsequential? A. Yes, that has always been taken as a matter of fact. I don't believe I have ever actually sat down and tried to figure it out, but the cost of removing the equipment from the facilities at the utility companies would be substantial and the salvage value is problematical. I would not say that salvage value would go over the cost of removing it.

Q. Then is it true that the motivation for your purchasing this stock was based on the potential in terms of monthly

service income which the corporation earned? A. I certainly believe that would be correct.

Q. If there is no salvage value, that is the only basis on which you could make any money, is that correct? A. Very probable.

* * * * * * * * * * *

48 Whereupon,

Edward J. Mallon

was called as a witness on behalf of the Petitioner and, having been first duly sworn, testified as follows:

* * * * * * * * * * *

50 Q. Did you offer any suggestions or counsel with respect to possible means of financing the company in contemplation of those problems? A. After some considerable study on the subject we advised them that with the available funds they had themselves they could not actually build or conceive what they were to complete their actual construction because the available capital that they had themselves was not enough to complete a $250,000 project. At that time it was decided that other funds would be needed to complete their task. After research as to how other companies had been financed, it was determined that other operations could be financed using customers' contributions in addition to the contributions by the investors.

Q. Is it correct to say, and correct me if I am wrong, that the decision to follow the route whereby the system would be financed essentially through contributions from respective customers or subscribers was conceived at the very outset of the company's organization? A. Yes. As a matter of fact, it was conceived before any construction was begun and before any moneys were paid into the company by either the investors or the customers themselves, and the attorneys drew the contracts in that form.

Q. Have you handled the accounting work for this company from the beginning down to the present time? A.

From the beginning down to the present time, yes.

51 Q. Did you aid in the preparation of the tax returns for the various years filed by the company? A. Yes, we did.

Q. Upon what theory did you prepare the returns, Mr. Mallon? I am thinking now with respect to contributions particularly. A. The returns were prepared following the accepted cases in contribution.

Q. Did you say accepted cases in the contributions in aid of construction, that line being the prescribed method of accounting that is followed?

The Court: Accepted cases, what are you talking about?

The Witness: The Detroit Edison case and a number of others which are cited in the original petitions.

By Mr. Morgan:

Q. Did the company claim upon its return depreciation upon any of this equipment? A. No. The accounting depreciation was shown, and it was taken as a non-deductible item on Schedule M.

Q. In view of your knowledge and familiarity with the books and records of this company I should like to ask you if based upon those records any of the sums received by way of contributions have been applied by the company toward interest, dividends, or anything else properly payable from earnings? A. On the books of the company

52 the accounting shows a separation of the sums received from contributions as against the sums received from the monthly maintenance charges. The actual funds, as has been testified to by Mr. Katrosh, were deposited in the bank account. They had one bank account, but the funds were segregated on the books of the company so that at all times the total amount received as contributions was obtainable and would be shown on the ledger as distinguished from any other funds received by the company.

Q. Is it correct, as Mr. Katrosh testified, based upon your knowledge of the books, that the total of the contributions never at any time equalled the actual cost of construction? A. That is correct. The accumulative amount received never equalled the accumulative amount spent.

Q. You have testified, I believe, that all contributions received were identifiably recorded upon the books and records of the company? A. Yes, they were.

* * * * * * * * * * *

53 Q. Mr. Mallon, you mentioned that the organizers of the Petitioner came to your firm and discussed with you the way that this corporation should be set up financially and also went over with you the estimated construction costs. Can you tell us how the original installment contribution of $145 for residential property and $200 for commercial property was arrived at? A. As near as I can state on that, it was determined that the construction costs would amount to about $250,000 if they covered the area which they had anticipated covering. The amounts of $145 and $200 were determined entirely on the basis that they knew the amount that was asked by other companies was approximately the same. They felt that if they acquired that amount of money from the number of prospective subscribers that they anticipated, they felt it would just about balance their construction cost. Now that is entirely speculative because you have too much speculation. First you are speculating on
54 cost and you are speculating on the number of subscribers you are going to get, so that the answer has to be in the speculative field.

Q. To the extent that you used other companies who were in the similar field, and you mention of course your estimate was of necessity speculative, did you take into account the potential of the areas which they were serving as against the potential of the Wilkes-Barre area? A. Yes, because I believe their estimates showed the larger the com-

pany, the larger the constructive costs; so that since the contribution was based on the constructive cost proportionately regardless of how large the company is, you are going to get the same answer. You divide the total cost by the total number of customers. The higher company has a higher cost on a higher number of customers, so it would relatively come out to the same figure.

Q. Isn't it true that you have certain basic costs, one being the antenna system, which would decrease? A. No. I am not an engineer, but as I understand the operation the only basic cost which does not increase as you increase the size of the system is the tower itself. Outside of that, every other cost is relative to the number of customers.

Q. In other words, you would agree with my statement?

A. I would say there has to be a proportion between
55 the cost and the number of customers you are going to serve, and it has to be directly proportionate to the number of customers.

The Court: is the cost of the antenna itself relatively large?

The Witness: No. The cost of the antenna itself usually runs from $1,500 to $3,000.

The Court: So it is a small item?

The Witness: Unless you have to purchase land to erect the tower on. Otherwise, it is a small item.

The Court: It still balances out ninety-six cents a foot?

The Witness: Ninety-six cents a foot. It all depends how big an area you are going to cover, and divide by the number of people in that area.

By Mr. Peil:

Q. In taking into account the charges that were made by other companies that were available to you in setting this rate, do you know whether those companies were making a profit on it? Were they recovering their costs based on these figures? A. I don't know the answer to that.

but I would say at that time the figures were probably so new it would have meant nothing anyhow because to my knowledge this company was only the third company in existence.

Q. You didn't specifically inquire into that as a basis? A. Yes, that is right.

56 Q. You say you did not? A. No. We were in contact with the other operators as to what they were charging purely as a guide as to what somebody else charges to see if our figures are far away from what somebody else's estimates were. That was purely the basis of it.

Mr. Peil: No further questions.

Redirect Examination

By Mr. Morgan:

Q. Mr. Mallon, pursuant to one of Mr. Peil's questions reference was made to the payment of some interest by the company on borrowed money. Was it the purport of your testimony that that interest was paid out of the contributions, from the contributions? A. No. That interest was paid out of the monthly maintenance charge. The amount of interest is relatively small because it is stipulated that the loans were anywheres from fifteen to thirty thousand dollars.

Mr. Peil: That interest was, however, paid out of the general account of the corporation?

The Witness: All checks were paid out of the general account of the corporation.

* * * * * * * * * *

Findings of Fact and Opinion

27 T. C. No. 84

Docket No. 57236. Filed January 29, 1957.

The taxpayer corporation promoted, constructed and now operates a community television antenna system in Wilkes-

Barre and Kingston, Pennsylvania. To help finance construction of the system, contributions were solicited from prospective customers. A contribution was a prerequisite to use of the system. It alone however, did not entitle the contributor to receive television signals. The contributor also had to make monthly payments, in advance, in order to receive the signals. A contributor could not sell, assign, or transfer his eligibility to receive television signals, but he remained eligible to receive the signals without additional cost if he moved to another part of Wilkes-Barre or Kingston. However, the person who moved into the contributor's old home was required to make a contribution in order to become eligible to use the system. The petitioner did not claim deductions upon its income tax returns for depreciation of the physical facilities of the system constructed from the funds contributed, but showed the accounting depreciation as a nondeductible item. *Held:* The contributions were not gifts to petitioner or contributions to its capital, but were part payment for services rendered or to be rendered and therefore includable in gross income under section 22(a), I.R.C., 1939.

TIETJENS, *Judge:* The Commissioner determined the following deficiencies in the petitioner's income taxes:

Year Ended	*Deficiency*
1-31-52	$ 3,210.83
1-31-53	13,013.09

Certain adjustments made by the Commissioner were not contested. The only issue presented in this case is whether "contributions" by subscribers to the petitioner's community antenna television system constitute gross income within the meaning of section 22(a) of the Internal Revenue Code of 1939.

FINDINGS OF FACT.

Some of the facts are stipulated. Those facts and the stipulated exhibits are found as stipulated and are incorporated herein by this reference.

The petitioner is a corporation whose address is 153 South Main Street, Wilkes-Barre, Pennsylvania. It was incorporated under the laws of the Commonwealth of Pennsylvania, in 1951. The petitioner filed its returns for the taxable years ended January 31, 1952 and 1953 with the district director of internal revenue at Scranton, Pennsylvania.

The petitioner promoted, constructed, and now operates for profit a community antenna television system at Wilkes-Barre and Kingston, Pennsylvania.

The residents of Wilkes-Barre and Kingston were unable by conventional television roof-top or built-in antennas to receive television signals of an adequate visual quality due to the fact that the cities were located in valleys surrounded by hills which effectively screened or cut off television signals which would otherwise be available for reception by conventional methods. Therefore in January 1951, the petitioner's incorporators determined that a company should be organized for the purpose of providing television signals to the residents of the Wilkes-Barre area through a community television system.

In 1951 no licenses for Ultra High Frequency (U.H.F.) television stations had then been issued, but there were indications that such licenses would be granted in the near future, and it was known that at least one company in Wilkes-Barre would make application for such license. This created a hazard of investing money in the enterprise.

The Radio Corporation of America (R.C.A.) provided engineers to make a survey of the projected system, and furnished estimates of the cost of the equipment and

materials that would be required. Two other community antenna systems were also investigated and on the basis of their experience and the advice received from R.C.A., it was estimated that it would cost 96 cents per foot for the trunk line cable or feeder line cable to be installed and erected. This cost tended to be constant, regardless of the size of the system, since the only fixed cost was that of constructing the antenna tower which was relatively small ($1,500 to $3,000). It was calculated that the cost of constructing a system to serve Wilkes-Barre and Kingston would be as much as $250,000.

The incorporaters held conferences with a certified public accountant with respect to the method of financing the company, including among other things, the cost of operation, availability of capital and money that could be borrowed. Before construction was begun or money paid into the company, it was decided that construction of the system would have to be financed essentially through contributions from prospective customers or subscribers.

Contributors were divided into two classes, residential and commercial. Contributions of $145 were solicited from the former and $200 from the latter. While installation costs were the same the incorporators believed that the commercial establishments could better afford to contribute a greater amount than could a private family. The amount of the original contributions was based upon construction costs and amounts solicited by other community antenna systems.

The charge for monthly maintenance of the system was set at $4 per month for residential subscribers and $6 per month for commercial subscribers. This charge was designed to cover the maintenance of the community antenna system and it included an element of profit. The rates were not set by any regulatory commission.

Findings of Fact and Opinion

The community antenna system was constructed in several distinct stages. The first step was the erection of a tower and intercepting antennas and the installation of a main trunk line cable, approximately five miles in length, to the first distribution area. Cost of the first step was borne by the incorporators. Before further extension of the system potential subscribers were solicited for service. When a sufficient number of applications had been received to indicate that the extension would be feasible the petitioner entered into contracts with the subscribers and then construction proceeded in the area in which the subscribers were located. Six months elapsed after completion of the initial construction before the first extension of the system was undertaken, 45 days before the second extension, and about 60 days before the third extension. It was estimated that at least 50 per cent of the cost of construction of the extensions would be borne by the contributions of the subscribers.

The contract which the subscribers signed provided as follows:

> Telso [petitioner] agrees to furnish Subscriber at the place of installation as noted above a television signal transmission service. Subscriber agrees, in consideration of contributions from other Subscribers, to contribute the sum of ..... Dollars toward the total cost of constructing a system for the transmission of a television signal. Subscriber agrees to pay Telso a monthly maintenance charge of ..... Dollars. The rights and obligations of the parties to this contract shall be subject to and governed by the statements made by Subscriber on the application and by the terms and conditions on the reverse side of this contract, entitled "General Provisions", number one through .....

Findings of Fact and Opinion

GENERAL PROVISIONS

* * * * * * * * *

Section 12—Termination of Service

(a) Termination—Public Utility Contracts—Government Permission

The service furnished by Telso under this contract is under and subject to the conditions of contracts entered into by Telso with various Railroads and Public Utilities and to the terms and conditions of resolutions of the cities, boroughs and townships in which the service is rendered, and to the terms and conditions of permits and licenses granted by various governmental agencies both state and federal. Insofar as they are relevant, the provisions of these contracts, municipal resolutions and governmental permits are by reference made a part of this contract. It is distinctly understood and agreed by Subscriber that the ability of Telso to continue service depends on the continuance in operation of the aforesaid contracts with the utilities, and with the continued authority granted by the various cognizant municipalities and governmental agencies. If for any reason, whether or not due to the neglect or fault of Telso, said public utility and railroad contracts or municipal resolutions or governmental permits as they now exist, or as they are subsequently amended, are cancelled, amended, abrogated, terminated or otherwise changed so as to make it, in the sole judgment of Telso, either impossible or impractical for Telso to furnish television transmission service under this contract, Telso shall have the right to terminate this contract. In the event of termination under this section, all contributions, maintenance rates, and other moneys paid Telso by Subscriber shall be forfeited. Subscriber shall not be entitled a refund of any kind.

(b) Termination—Default by Subscriber

Telso may terminate this contract by written notice to Subscriber whenever Subscriber violates a provision of this contract and the right to terminate for default is given to Telso. Whether Subscriber has violated the contract shall be a matter for the sole

determination of Telso. If Telso terminates this contract under the provisions of this section, Subscriber shall not be entitled to a refund of any kind, and Telso shall in no wise incur any liability.

(c) Termination—For Convenience of Subscriber or Telso

Subject to the provisions of Sections (a) and (b), and subject to the failure of service as provided in Section 1 (c) and (d), either the Subscriber or Telso may terminate this contract on thirty (30) days written notice to the other. A termination notice addressed to the Subscriber at the address appearing on this contract, with postage prepaid, shall be compliance with notice under this Section.

(1) If Telso terminates this contract under this section, Subscriber shall be refunded a part of his contribution money, as follows:

i. A maximum of Sixty (60) Dollars less Ten (10) Dollars for each month this contract has been in effect.

ii. There shall be no refund of any other charge.

(2) If Subscriber terminates this contract under this section, Subscriber shall not be entitled to a refund of any kind.

* * * * * * * * *

Section 17—Assignment

Neither this contract nor any interest herein nor any claim arising hereunder shall be assigned by the Subscriber.

While a contribution was a prerequisite to use of the system, it alone did not entitle the contributor to receive television signals. The contributor also had to make monthly payments, in advance, in order to receive the signals.

A contributor could not sell, assign, or transfer his eligibility to receive television signals, but he remained eligible to receive the signals without additional cost if

he moved to another part of Wilkes-Barre or Kingston. However, the person who moved into the contributor's old home was required to make a contribution in order to become elibible to use the system.

No change was ever made in the $4 monthly charge for maintenance in the case of a residence, or in the $6 monthly charge in the case of a commercial establishment. Also the $200 contribution required of commercial establishments was never changed. However, the amount required of residential subscribers was reduced to $89 on January 1, 1953, to $80 on June 1, 1954, to $30 in August 1955, and no contributions have been required since the beginning of 1956.

The greatest number of connections in operation at one time was about 900 and the least was about 200 to 300. In 1956 there were about 400 connections in operation. The decrease in connections resulted in 1952 when U.H.F. licenses were granted to local television stations in Wilkes-Barre and Scranton. The number of contributions also fell off sharply at that time.

During the period February 20, 1951 to January 31, 1952, the petitioner received under contracts initial payments, other than payments for monthly maintenance, totalling $27,601.98; during the same period construction costs of the system totalled $62,880.64.

During the period February 1, 1952 to January 31, 1953, the petitioner received under contracts initial payments, other than payments for monthly maintenance, totalling $88,544.79; during this same period construction costs of the system totalled $70,620.78.

The television antenna systems equipment had no salvage value.

All initial payments received by the petitioner were credited to an account maintained in its books and records called "Customer Contributions." Segregation of the funds paid as contributions was maintained on the books of accounts of the petitioner, as against sums received

from monthly maintenance charges. The funds were deposited in the petitioner's general bank account from which were paid general operating expenses and the cost of all assets acquired. However the petitioner's accounting system segregated the costs of construction and the amounts contributed. At no time has the total amount of contributions ever equalled the capital outlay required to construct the system.

The petitioner did not claim deductions upon its income tax returns for depreciation of the physical facilities of the community antenna television system but showed the accounting depreciation as a nondeductible item.

Ultimate Finding

The "contributions" to the petitioner were not gifts or contributions to capital; they were part of the payment for services rendered or to be rendered by the petitioner and are includable in petitioner's gross income.

Opinion

The Commissioner included the above referred to "contributions" in the petitioner's gross income during the taxable years and determined a deficiency accordingly. In such determination he allowed the petitioner a deduction for depreciation of the physical assets of the community antenna television system. The propriety of the Commissioner's determination is the issue involved in this case.

The petitioner takes the position that the contributions were contributions in aid of construction and thus not subject to taxation as income. It relies upon the following alleged characteristics of the contributions to show that they were in aid of construction: (1) the parties intended that the contributions be devoted to construction of the capital facility; (2) the contributions were so denominated by contract; (3) the amount of the contribution was reduced from time to time so as not to exceed the costs of

construction; (4) the contributions were treated in tax returns and on the books as contributions in aid of construction; (5) the contributions never exceeded construction costs and never were intended to provide and did not provide a source for payment of dividends, interest, etc., the monthly maintenance charge being, as intended, the only source of profit; (6) the capital facilities were without salvage value, thus obviating any possibility of gain to the petitioner from the contributions; and (7) the contributions were never made nor received for services rendered or to be rendered and they conferred no direct benefit upon the contributor, since he was required to make monthly payments as a condition precedent to receiving monthly service from the antenna system. As authority for its position that contributions in aid of construction are not taxable as income, the petitioner cites: *Edwards* v. *Cuba Railroad*, 268 U.S. 628 (1925); *Liberty Light & Power Co.*, 4 B.T.A. 155 (1926); *Great Northern Railway Co.*, 8 B.T.A. 225 (1927), aff'd. 40 F.2d 372, certiorari denied 282 U.S. 855; *Texas & Pacific Railway Co.*, 9 B.T.A. 365 (1927); *Rio Electric Co.*, 9 B.T.A. 1332 (1928); *Wisconsin Hydro-Electric Co.*, 10 B.T.A. 933 (1928); *El Paso Electric Railway Co.*, 10 B.T.A. 79 (1928); *Tampa Electric Co.*, 12 B.T.A. 1002 (1928); *Midland Valley Railroad Co.*, 19 B.T.A. 423 (1930); *Union Pacific Railroad Co.*, 26 B.T.A. 1126 (1932); and *Texas & Pacific Ry. Co.* v. *United States*, 52 F. 2d 1040 (Ct. Cl. 1931), aff'd without discussion of this point 286 U.S. 285 (1932).

In *Edwards* v. *Cuba Railroad*, *supra*, the taxpayer received certain properties and money subsidies from the Republic of Cuba in connection with the construction of a railroad line. The taxpayer built the railroad itself and owned it, but the Cuban Government paid it a certain amount per mile as the work progressed pursuant to an offer which was designed to induce some one to build a railroad. The Supreme Court held that the subsidy payments did not constitute income within the meaning of the

Sixteenth Amendment since they were not made for services rendered or to be rendered and were not profits or gains from the use or operation of the railroad, but were made to reimburse the taxpayer for capital expenditures. In *Liberty Light & Power Co., supra*, individuals desiring to obtain electric service constructed transmission lines and transferred them to the taxpayer who was required by law to maintain them and furnish service to the individuals. The Board of Tax Appeals (now the Tax Court) held that the transmission lines did not constitute income to the taxpayer under the rule of the *Cuba Railroad* case. It said that the transmission lines were contributed by the individuals to the capital of the taxpayer and were not payment for services rendered or to be rendered. In *Great Northern Railway Co., supra*, it was the practice of the taxpayer, where an industry located along its tracks desired transportation facilities from its plant, to construct the necessary spur track, take title to so much thereof as lay on its right-of-way, and require the industry to pay the cost of construction. The Board of Tax Appeals held that such payments were contributions in aid of construction and did not constitute income, under the rule of the *Liberty Light* case. The other cases cited by the petitioner, *supra*, involve factual situations which are substantially identical to those involved in the *Liberty Light* and *Great Northern Railway* cases, and the rule of those cases was held controlling.

The Commissioner contends that the contributions are includable in the petitioner's gross income under section 22(a) of the Internal Revenue Code of 1939. His position is that section 22(a) taxes all gains constitutionally taxable except those specifically exempted, and he cites as authority, *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426 (1955) and *Gen. Investors Co.* v. *Commissioner*, 348 U.S. 434 (1955). He contends that such contributions are constitutionally taxable and that they are not specifically

exempted from taxation since they are neither gifts nor contributions to capital.

We agree with the Commissioner.

During the taxable years, only those persons who made contributions to the petitioner's community television antenna system were eligible to use such system upon further payment of monthly charges. Those who did not make contributions could not use the system. A contributor could not sell, assign, or transfer his eligibility to receive television signals, although once having contributed he remained eligible to receive the signals even though he moved to a different part of Wilkes-Barre or Kingston. However the person who moved into the original contributor's old home was required to make a contribution of his own in order to become eligible to use the system. It should be noted that under certain circumstances part of a contribution was refundable, but we are not concerned with these provisions, since the controversy here relates only to payments which by the contracts have ceased to be refundable. We see nothing in the contracts between the petitioner and subscribers that bound the petitioner to use the "contributions" for any particular purpose.

In view of these characteristics we have made an ultimate finding that the contributions are not gifts or contributions to the petitioner's capital, but are part of the price of services rendered or to be rendered. We think that this finding is inevitable in spite of the voluminous authority cited by the petitioner to support its position that the contributions are in aid of capital construction and thus are not taxable income.

In *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98 (1943), the taxpayer was engaged in the generation of electricity and its distribution to the public. The taxpayer received applications for service, which, in its opinion, required an investment in extension of its facilities greater than prospective revenues therefrom warranted. In such cases it would render the services if the applicant would

pay the estimated cost of the necessary construction. The taxpayer would construct the facilities which then became its property and add the full cost to its appropriate property accounts without deduction for the customer payment. It claimed as a base for depreciation the investment for which it was reimbursed. In holding that it was improper for the taxpayer to include the amount of the customer contributions in its basis for depreciation, the Court said:

> The Company, however, seeks to avoid this result by the contention that what it has obtained are gifts to it or contributions to its capital of the property paid for by the customer, and that therefore * * * it takes the basis of the donor or transferor. It is enough to say that *it overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company. The trasaction neither in form nor in substance bore such a semblance.*
>
> *The payments were to the customer the price of the service.* * * * [Emphasis supplied]

We are unable, in substance, to distinguish between the facts of the *Detroit Edison* case and the case at bar. Nor are we able, in substance, to distinguish factually between the *Detroit Edison* case and every one of the cases cited above by the petitioner except *Edwards* v. *Cuba Railroad*. In spite of the sheer weight in number of those decisions, we feel bound to make an ultimate finding consistent with that of the *Detroit Edison* case, and what in our view appears to be a gradually but persistently broadening concept of taxable income as exemplified by the *Glenshaw Glass Co.* and *Gen. Investors Co.* cases, *supra*. As for the *Cuba Railroad* case, which the petitioner so strongly relies upon, we think that case is clearly distinguishable from the present one due to the character and motive of the contributor involved therein. There, the Republic of Cuba was the contributor. Its motive in making the con-

tributions was governmental and altruistic; the sovereign had the public interest in mind when it offered the subsidies to induce the construction of a railroad. The subsidies were not given to obtain concessions in respect of rates for government transportation. Here we have an entirely different situation. Paraphrasing the dissent in *Liberty Light & Power Co., supra*, there was nothing altruistic in the motive which prompted the petitioner's prospective customers to finance the television antenna system; they wanted television service and they were willing to pay for it. If the system had already been constructed and available they would have paid a larger monthly charge and this unquestionably would have been within the petitioner's gross income. Since the facilities were not available and due to the risk involved, the only way that the petitioner could be induced to give service was by the receipt of something in addition to the monthly charge, namely, contributions to enable it to construct extensions of the antenna system. Contributions received in this manner are within the gross income of the petitioner.

We think that the Supreme Court, in deciding the *Cuba Railroad* case, did not intend that the theory of that case should be extended so as to free from taxation a private contribution made in consideration of the performance of the contributee's normal business function. We have support for this view from the *Detroit Edison* case, where the Supreme Court said:

> [The contributions] have not been taxed as income, presumably because it has been thought to be precluded by this Court's decisions in *Edwards* v. *Cuba R. Co.*, * * * holding that under the circumstances of that case a government subsidy to induce railroad construction was not income.

We hold that the contributions in this case are not gifts or contributions to the petitioner's capital, but are the price of services rendered or to be rendered and accord-

ingly they are includable in the petitioner's gross income under section 22(a).

Reviewed by the Court.

Decision will be entered for the respondent.

OPPER, J., concurring: In *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, depreciation deductions were denied on the ground that the taxpayer had no basis. The circumstances under which it had acquired the property seem to me indistinguishable from those present here. There, as here, the taxpayer had no cost. It was assumed that the only way a basis could be achieved was by treating the acquisition as a gift thereby conferring the basis of the transferor. This theory the Supreme Court refused to adopt.

Speaking of the treatment of the acquisitions from the standpoint of taxable income, all that is clear is that they had not been taxed or reported, presumably on the authority of *Edwards* v. *Cuba R. Co.*, 268 U.S. 628. *Detroit Edison* takes no position as to the correctness of that treatment and I agree with the present opinion that we are free to decide here that the value of the contributions constituted income taxable to petitioner in that it was not a gift, *Detroit Edison Co.* v. *Commissioner*, *supra*, nor a contribution to capital. Cf. *Brown Shoe Co.* v. *Commissioner*, 339 U.S. 583.

But under the *Detroit Edison* dictum there are only two possibilities. The first is that the contributions never were taxable income and in that event, of course, the present result would be incorrect. The second possibility is that although they should have been reported as taxable income they failed to attain a basis for depreciation because they had never been taken up in the taxpayer's income. Theoretically, where, as in *Detroit Edison* and here, only cost can furnish a basis, the basis would be zero where there is no actual cost. *Helvering* v. *Gowran*, 302 U.S. 238. But where the subject matter has been taken up in income, courts thought it equitable to attribute a basis to that ex-

tent. *Maurice P. O'Meara*, 8 T.C. 622; see *Artis C. Bryan*, 16 T.C. 972; *Johnson* v. *Commissioner*, (C.A. 5) 162 F. 2d 844.[1]

The difficulty with the second hypothesis is that less than 3 months after the *Detroit Edison* opinion was handed down, the Second Circuit held that a taxpayer could take a deduction for a loss on property which should have been but never was reported for tax purposes, even though there was no cost or other statutory basis. *Bennet* v. *Helvering*, (C.A. 2) 137 F. 2d 537. This result was reached without any reference to *Ruth B. Rains*, 38 B.T.A. 1189, upon which the opinion below had been grounded. The *Rains* case was itself merely the culmination of a long line of similar results.[2]

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[1] On the other hand it is said that if she had returned the gain in 1929 and paid taxes on it, the fair value thus capitalized into the property would have been recognized as a proper basis in fixing the gain on the sale in 1938.

* * * * * * *

Since the value was not then or since taken into the tax account as a capital investment, there is no occasion to add it to the basis of the property when sold to avoid taxing it a second time. Justice has been done. * * * [*Johnson* v. *Commissioner*, *supra* at 846.]

[2] The cases last above cited [*Pearl A. Long*, 35 B.T.A. 479; affd., 96 Fed. (2d) 270; *George N. Crouse*, 26 B.T.A. 477; *Searles Real Estate Trust*, 25 B.T.A. 1115; *Henry V. Poor*, 11 B.T.A. 781; affd., 30 Fed. (2d) 1019; *Bothwell* v. *Commissioner*, 77 Fed. (2d) 35; *Larkin* v. *United States*, 78 Fed. (2d) 951] are predicated upon the general principle that a taxpayer can not take as a deduction the loss of a gain which has not been reflected in income. For example, in the *Poor* case, *supra*, the taxpayer deducted from gross income as a bad debt the full amount of a judgment embracing $484.21 interest which had at no time been included in his reported income. The Board applied the principle stated, notwithstanding the taxpayer kept his books on a cash receipts and disbursements basis, and the uncollected interest, therefore, was properly excluded from his gross income.

In the instant case, petitioner is not seeking to deduct directly from gross income the amount of the uncollected royalties, and if such a deduction were claimed, it would not be allowable under the doctrine referred to. However, petitioner is attempting to attain the same result by including the amount of the royalties in the basis to be deducted in computing gain or loss * * *

Substantially the same principle has been applied and the same results obtained in analogous situations based upon slightly different reasoning. In *William Merriam Crane*, 27 B.T.A. 360; affd., 68 Fed. (2d) 649, the petitioner owned certain realty which had been leased to an insurance company. The lessee made improvements of substantial value in 1920 which were to revert to the lessor upon termination of the lease. Petitioner sold the property in 1927, and contended that in computing gain or loss on the sale he was entitled to deduct the depreciated cost of the improvements, although he had never

Basis for gain or loss and basis for depreciation being for all practical purposes identical—with adjustments and exceptions not here pertinent, sections 113 and 114, Internal Revenue Code of 1939; *Johnson* v. *Commissioner*, *supra*—the reasoning of the *Bennet* case would mean that *Detroit Edison* must inferentially have decided that the contributions involved there had never been properly reportable as taxable income. In other words, if the *Bennet* result is right, the present conclusion must be wrong.

But since I think the theory of the *Bennet* case cannot be supported,[3] I agree with this result.

KERN, *J.*, dissenting: In this case we are not concerned with the effect of the contributions here involved on petitioner's basis for depreciation with regard to the property purchased with those contributions, but with the question of whether these contributions constitute income taxable to petitioner. In my opinion, they were contributions of capital made by the contributors in order to furnish the funds necessary for the construction of a television signal transmission system by a corporation just starting out in business and having itself insufficient capital with which

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reported any part of such cost or value in his income. We denied the deduction on the ground that an income item is not, for tax purposes, converted into a capital asset, having a cost basis, until it is first taken into income. * * *

In *Commissioner* v. *Farren*, 82 Fed. (2d) 141, the taxpayers in 1918 each received shares of stock in an oil company as compensation for services rendered. Although taxable as income for 1918, no return was made for that year, on the theory that no income was derived until the stock was sold. The stock was sold in 1926, and the taxpayers contended they were entitled to deduct the value of the stock when acquired, notwithstanding such value had not been returned as income. The deduction was disallowed.

In *Long* v. *Commissioner*, 96 Fed. (2d) 270, affirming 35 B.T.A. 479, the court held that the worthless obligation of a husband to pay alimony was not deductible as a bad debt, since there was no cost basis of the debt sought to be deducted.

In *Alamo National Bank of San Antonio, Executor*, 36 B.T.A. 402; aff'd., 95 Fed. (2d) 622, the petitioners were the sole stockholders of a corporation from which they received a Coca Cola franchise in 1921 as a liquidating dividend, but did not include in their income for that year any amount on account of the receipt of the franchise. They sold the franchise in 1931, and we held they were not entitled to deduct any value for the franchise as a basis for computing gain from its sale. [*Ruth B. Eaton*, *supra* at 1196, 1197.]

[3] See Footnote 2, *supra*.

to construct such a system. It is obvious that without these contributions, which furnished 87 per cent of the funds spent for the construction of the necessary facilities by petitioner during the period February February 20, 1951, to January 31, 1953, petitioner could not and would not have begun business. I am unable to see why these contributions, which in my opinion were contributions to petitioner's capital, must be taxed as income to petitioner merely because the ultimate motive of the contributors was their interest in obtaining services which could not have been available to them unless and until they had furnished by this means the capital which petitioner required in order to erect the facilities necessary for the furnishing of such services.

In my judgment, the situation presented by the instant case is distinguishable from that referred to by the dictum in the *Detroit Edison* case quoted in the majority opinion—a dictum appearing in an opinion which considered the question of basis for depreciation rather than the question of whether the contributions constituted income. In any event, it would seem to me to be better judicial technique for this Court to follow the clearly applicable and heretofore unreversed precedents furnished us by *Edwards v. Cuba Railroad Co.*, 268 U.S. 628; *Great Northern Railway Co.*, 8 B.T.A. 225, aff'd 40 F. 2d 572, certiorari denied, 282 U.S. 855, and the other cases noted in the majority opinion, rather than to assume from "a gradually but persistently broadening concept of taxable income * * * exemplified by the *Glenshaw Glass Co. and General American Investors Company* cases" that the Supreme Court, by its dictum in the *Detroit Edison* case, intended to overrule the long line of cases starting with *Edwards v. Cuba Railroad Co., supra.*

Upon the facts of the instant case, and applying the law as it is revealed to us by existing precedents, it is my judgment that the issue before us should be decided in favor of the petitioner, and I, therefore, note my dissent.

Decision

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion, filed January 29, 1957, it is

ORDERED AND DECIDED: That there are deficiencies in income tax for the fiscal year ended January 31, 1952 in the amount of $3,210.83 and for the fiscal year ended January 31, 1953 in the amount of $13,013.09.

/s/ NORMAN O. TIETJENS
Judge

Entered: January 29, 1957.

APPENDIX B

Statutes and Regulations Involved

Statutes

Internal Revenue Code of 1939, as amended:

Sec. 21. Net income.

(a) Definition. "Net income" means the gross income computed under section 22, less the deductions allowed by section 23. (Act of February 10, 1939, 53 Stat. 9, as amended).

Sec. 22. Gross income.

(a) General definition. "Gross income" includes gains, profits, and income derived from salaries, wages or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or

sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *"

(Act of February 10, 1939, 53 Stat. 9, as amended).

Internal Revenue Code of 1954:

Sec. 61. Gross income defined.

(a) General definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

(Act of August 16, 1954, c. 736, 68A Stat. 17).

Sec. 118. Contributions to the capital of a corporation.

(a) General rule.—In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer. (Act of August 16, 1954, C. 736, 68A Stat. 39).

Sec. 362. Basis to corporations.

• • •

(c) Special rule for certain contributions to capital.—

(1) Property other than money.—Notwithstanding subsection (a)(2), if property other than money—

(A) is acquired by a corporation, on or after June 22, 1954, as a contribution to capital, and

(B) is not contributed by a shareholder as such, then the basis of such property shall be zero.

(2) Money.—Notwithstanding subsection (a)(2), if money—

(A) is received by a corporation, on or after June 22, 1954, as a contribution to capital, and

(B) is not contributed by a shareholder as such, then the basis of any property acquired with such money during the 12-month period beginning on the day the contribution is received shall be reduced by the amount of such contribution. The excess (if any) of the amount of such contribution over the amount of the reduction under the preceding sentence shall be applied to the reduction (as of the last day of the period specified in the preceding sentence) of the basis of any other property held by the taxpayer.

Regulations

The particular properties to which the reductions required by this paragraph shall be allocated shall be determined under regulations prescribed by the Secretary or his delegate.

(Act of August 16, 1954, c. 736, 68A Stat. 118).

Regulations

Treasury Regulations 111 (Internal Revenue Code of 1939):

Sec. 29.21-1. Meaning of net income.—

* * *

(a) Income (in the broad sense), meaning all wealth which flows in to the taxpayer other than as a mere return of capital. It includes the forms of income specifically described as gains and profits, including gains derived from the sale or other disposition of capital assets. * * *

(b) Gross income, meaning income (in the broad sense) less income which is by statutory provision or otherwise exempt from the tax imposed by chapter 1. (See section 22.)

(c) Net income, meaning gross income less statutory deductions.

* * *

Sec. 29.22(a)-1. What included in gross income.—

Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22(b) and 116.) In general, income is the gain derived from capital, from labor, and from both combined, provided it is understood to include

profit gained through a sale or conversion of capital assets. * * *

Income Tax Regulations (Internal Revenue Code of 1954):

Sec. 1.118-1. Contributions to the capital of a Corporation.

In the case of a corporation, section 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer. Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. Section 118 also applies to contributions to capital made by persons other than shareholders. For example, the exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production. See section 362 for the basis of property acquired by a corporation through a contribution to its capital by its stockholders or by nonstockholders.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1957

No. 983

TELESERVICE COMPANY OF WYOMING VALLEY, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1957

No.

TELESERVICE COMPANY OF WYOMING VALLEY, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit, entered in the above-entitled case on March 24, 1958.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court of the United States are reported at 27 T.C. 722 (1957) and appear in the record at pages 17-34. The concurring opinion of Judge Opper begins at page 31 and the dissenting opinion of Judge Kern begins at page 33.

The opinion of the United States Court of Appeals for the Third Circuit is not yet reported, and appears as Appendix A of this petition.

JURISDICTION

The judgment of the Circuit Court of Appeals sought to be reviewed was entered on March 24, 1958. On April 8, 1958, the Circuit Court of Appeals stayed the issuance of its mandate until May 8, 1958.

The jurisdiction of this Court is invoked under Section 1254(1) of the Judicial Code, 28 U.S.C., § 1254(1).

QUESTION PRESENTED

Petitioner, a pioneer community antenna television system, finding sufficient risk capital unavailable, solicited funds from prospective subscribers toward the total cost of constructing its facilities. The sums received, which were not claimed as a basis for depreciation, have been held to be includable within taxable gross income, because only subscribers making contributions thereby became eligible to receive monthly service in return for the payment of monthly service charges.

The question presented in whether the doctrine enunciated by this Court in 1925 in *Edwards* v. *Cube Railroad Co.*, 268 U.S. 628, which has received a uniform application for thirty years, that reimbursements for capital expenditures are not includable in gross income although contributors may receive direct benefits from operation of the facility, is no longer applicable in income tax cases because of language interpreted as "an illuminating guide" in the decision of this Court in 1943 in *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, holding that such contributions not included in gross income may not be allowed as a basis for depreciation.

STATUTE INVOLVED

Internal Revenue Code of 1939, as amended:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * (Act of February 10, 1939, 53 Stat. 9, as amended, 26 U.S.C. (1952 ed.), § 22(a).)

STATEMENT OF THE CASE

The facts of this case are not in dispute, and are set forth in the opinion of the Court of Appeals printed in Appendix A hereto. They may be summarized briefly as follows:

Petitioner promoted, constructed, and operates a community antenna television system, a facility consisting of a master antenna mounted at a high elevation, with amplifiers, cable lines, and related equipment, which is designed to provide otherwise unavailable television programs to the residents of mountain-locked or fringe communities. In January 1951, when petitioner was organized to provide a first tele-

vision service to the cities of Wilkes-Barre and Kingston, Pennsylvania, which were effectively screened by intervening terrain from television reception through the conventional built-in, "rabbit-ear," or roof-top antennas, a single community antenna system had begun operation at Lansford, Pennsylvania, and a second was being constructed at Pottsville, Pennsylvania.

There was thus no adequate precedent to follow and insufficient information available based on past experience. It was expected that television stations would be established in the area in the near future to provide direct local service, and licenses were in fact granted in 1952 to area stations. It was known that it would be necessary to lay five miles of costly "dead" trunkline cable before a populated area could be reached to provide any significant potential for service. The cost of constructing the system was calculated to be as much as a quarter of a million dollars.

Because of the risks involved, and the impossibility of realizing a profit from undertaking the entire investment, petitioner decided that construction of the system would have to be financed essentially through contributions from prospective subscribers. Any profit to be realized would come from monthly service charges. Contributions of $145 were required of residential subscribers, and $200 upon commercial establishments, based upon the latter's ability to afford a greater amount. It was expected that anticipated contributions in these amounts would just about balance the estimated over-all costs of construction. Thereafter residential contributions were successively reduced to $89, to $80, to $30, and were finally abolished

in 1956. Monthly service charges designed to cover maintenance and to include an element of profit, in the amount of $4 per month to residential customers and $6 to commercial customers, have remained constant from the beginning.

Petitioner first erected the master antenna tower and laid five miles of cable to the first distribution area, using its own funds, before proceeding with successive stages of operation upon securing a sufficient number of prospective subscribers to enter into contracts. Petitioner agreed therein to furnish service, and the subscriber agreed to contribute a specified sum toward the total cost of constructing the system, which was a prerequisite to eligibility to use the system, and a monthly maintenance charge, payable in advance, which entitled him to receive television signals for that term. The contract also provided for forfeiture of contributions and charges in the event of termination, unless for the convenience of petitioner, in which case a partial refund on a sliding scale was provided. Potential subscribers were advised that the contributions were in aid of construction of the facility for supplying the television signals, and had no bearing on service, which would be charged as an extra item. A contributor could not sell, assign, or transfer his eligibility to receive signals, but remained eligible if he moved within the service area of the system, but a person moving into the contributor's old home was required to make a contribution in the amount then obtaining to become eligible. Connections fluctuated between a high of 900 and a low of 200 or 300.

During the two tax years in question, petitioner received total contributions of $116,146.77, and expended a total of $133,501.42 toward construction. The commu-

nity antenna system has no value as salvage. At no time did total contributions ever exceed total construction costs. All contributions were applied to construction costs, the operating costs being paid only from monthly service charges. All funds were deposited in petitioner's general bank account. However, its accounting system segregated the costs of construction, the amounts received as contributions, and the sums received from monthly maintenance charges.

In filing its income tax returns, petitioner did not include the contributions from subscribers in its gross income, and also did not claim an allowance for depreciation upon the physical facilities of the system, showing the accounting depreciation as a non-deductible item. The Commissioner, on the contrary, treated the contributions as gross income, but allowed a depreciation deduction, claiming tax deficiencies of $3,210.83 and $13,013.09 for the two taxable years in question.

Pursuant to the provisions of Section 6213 of the Internal Revenue Code of 1954, taxpayer filed a petition with the Tax Court of the United States on April 4, 1955, for a redetermination of the tax deficiencies claimed by the Commissioner. Findings of fact, opinion, and decision were filed on January 29, 1957, by Judge Tietjens of the Tax Court, after review by the Court (Opper, J., concurring, and Kern, J., dissenting), holding that the sums received toward the total cost of constructing the system constituted gross income within the meaning of Section 22(a) of the Internal Revenue Code of 1939. Pursuant to the provisions of Sections 7482 and 7483 of the Internal Revenue Code of 1954, a petition for review was filed on February 12, 1957, with the United States Court of Appeals for the Third Circuit, which affirmed the decision

of the Tax Court by opinion and judgment entered on March 24, 1958.

REASONS FOR ALLOWANCE OF THE WRIT

1. The Decisions of the Courts Below Are in Direct Conflict With Thirty Years of Judicial Application of the Doctrine of Edwards v. Cuba Railroad Co.

For thirty years until the instant case, every Court which has considered the question has uniformly held that reimbursements for capital expenditures are not taxable as income, although the contributors may receive direct benefits from operation of the facility, following the doctrine of *Edwards* v. *Cuba Railroad Co.*, 268 U.S. 628 (1925).[1] This Court had there stated, 268 U.S. at 632:

> "Such aids gifts and grants from the government, subordinate political subdivisions or private sources—whether of land, other property, credit or money—in order to induce construction and operation of railroads for the service of the public are not given as mere gratuities. * * *"

In that very case an entire series of direct benefits and concessions, including the right to specify routes and receive special rates, were granted by contract to the donor foreign government in return for its payments as reimbursement for railroad construction.

Thereafter, in those income tax cases where *Edwards* v. *Cuba Railroad* was held not applicable, the distinction made was not based upon any inquiry into the motives of or benefits to the contributors, but upon the nature of the funds in the hands and from the viewpoint of the taxpayer. In each such instance, *Edwards*

[1] Some of the cases following that decision, described by the Tax Court below as "voluminous authority", (R. 28), are set forth in that Court's decision. (R. 26). Cf. App., p. 9a.

v. *Cuba Railroad* was distinguished because the payments were related to operation and not to capital expenditures. As this Court said in *Texas & Pacific R. Co.* v. *United States*, 286 U.S. 285, 289-290 (1932):

> "The sums received under the act were not subsidies or gifts—that is, contributions to the capital of the railroads—and this fact distinguishes cases such as Edwards v. Cuba Railroad Co., 268 U.S. 628, where the payments were conditioned upon the construction work performed. Here they were to be measured by a deficiency in operating income, and might be used * * * just as any other operating revenues might be applied. * * *"

To the same effect are *Continental Tie & Lumber Co.* v. *United States*, 286 U.S. 290, 293-294 (1932); *Kansas City Southern Ry. Co.* v. *Commissioner*, 52 F. 2d 372, 378 (8th Cir., 1931), cert. den. 284 U.S. 676 (1931); *Boston Elevated Ry. Co.* v. *Commissioner*, 131 F. 2d 161, 164-165 (1st Cir., 1942), cert. den. 318 U.S. 760 (1943); *Helvering* v. *Claiborne-Annapolis Ferry Co. of Annapolis, Md.*, 93 F. 2d 875, 876-877 (4th Cir., 1938).

Indeed, the reference by this Court to the *Texas & Pacific R. Co.* case in *General American Investors Company* v. *Commissioner*, 348 U.S. 434, 436 (1955), a case relied upon by the Courts below to apply their broadened concept of taxable income, can only be interpreted as an affirmation of the test for non-taxable contributions there enunciated. In its companion case, *Commissioner* v. *Glenshaw Glass Company*, 348 U.S. 426 (1955), when it was in the lower Court, 211 F. 2d 928, 931 (3d Cir., 1954), Chief Judge Biggs restated without qualification in the same paragraph cited herein by the Court below (App., p. 15a), the applicable

rule: "If the property or money paid represents a return of capital or a contribution to capital it is not subject to income taxation."

The Courts below have now ruled that the funds received for construction of a capital facility are includable in gross income, if they are paid by prospective subscribers as a condition to their becoming eligible, upon prepayment of a monthly service charge, to obtain direct service from operation of the facility. No cases are cited directly in support, but reliance is placed upon language in *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98 (1943), as "an illuminating guide," (App., p. 12a), and upon the interpretation of that case in *Brown Shoe Co.* v. *Commissioner*, 339 U.S. 583 (1950) and *Commissioner* v. *McKay Products Corporation*, 178 F.2d 639 (3d Cir., 1949). But the non-taxability of the contributions as gross income was not before the Court in *Detroit Edison Co.* v. *Commissioner*, 319 U.S. at 103, or in *Brown Shoe Co.* v. *Commissioner*, 339 U.S. at 587 fn. 5.* The question there presented was whether such contributions could *also* be claimed as a basis for depreciation.

Two different tax worlds are concerned which cannot be so readily bridged as sought by the Courts below. One concerns income, the other a depreciation allowance. One is based upon constitutional limitation and

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* When that case was before the Court of Appeals, *Commissioner* v. *Brown Shoe Co.*, 175 F. 2d 305, at 311 (8th Cir., 1949), the Court quoted the Commissioner's brief as follows:

> "'Although the contributions here in question were undoubtedly contributions to the taxpayer's capital in the general sense of that term, so as to distinguish them from its income, they do not constitute "a contribution to capital" within the meaning of that term as it is used in Section 718(a)(1) and (2) of the Internal Revenue Code * * *.'"

statutory exclusion, the other upon a matter of legislative grace. One is to be construed strictly against the Government, the other against the taxpayer. One applies a test of capital as against operational expenditures, the other a test of direct as against indirect benefits. While both use the same phrase "contributions to capital," the *Cuba Railroad* income tax cases are based upon the distinction between capital and income, while the *Detroit Edison* depreciation cases turn upon the equating of "contributions" to "gifts" to secure a legislative exemption. In the *Cuba Railroad* doctrine, it was never a requirement that the "contributions" be gifts, as emphasized in the briefs and opinion filed therein.

Nor is an element of a community or public benefit a valid distinction to support the decisions below. Certainly there is no greater public purpose to be served in building railroad lines or subsidizing private factories than in extending railroad, gas, electric power, telephone, or water lines to rural areas, or, as here, in bringing a first or auxiliary television service to residents of screened areas. To promote and realize the maximum benefits of radio and television service to all the people of the United States has been expressly avowed to be a matter of national policy. *National Broadcasting Co.* v. *United States*, 319 U.S. 190, 217 (1943). By providing a facility for consistent, adequate, and satisfactory reception of television programs not otherwise available to isolated or fringe communities, the community antenna television system furthers this declared policy to secure and "make available, so far as possible, to all the people of the United States a rapid, efficient, Nation-wide, and world-wide wire and radio communication service with adequate

facilities at reasonable charges * * *." Communications Act of 1934, Sec. 1, 48 Stat. 1064, as amended, 47 U.S.C., § 151.

The decisions of the Courts below are directly in conflict with a long line of heretofore unreversed decisions of the Board of Tax Appeals, predecessor of the Tax Court, as the Courts below have candidly conceded (App., pp. 15a-16a):

> "As to *Liberty Light & Power Co.*, 4 B.T.A. 155 (1926), *Great Northern Railway Co.*, 8 B.T.A. 225 (1927) aff'd 40 F.2d 327 (8th Cir. 1930), cert. den. 282 U.S. 855 and cases which followed the rule they enunciated, we can only say we are not in accord. We agree with the Tax Court that these cases cannot be distinguished factually."

The decisions of the Courts below are directly in conflict with the decision of the Court of Claims in *Texas & P. Ry. Co.* v. *United States*, 52 F.2d 1040 (Ct. Cl., 1931), aff'd 286 U.S. 285 (1932) (discussed supra in this petition), which held under circumstances which "cannot be distinguished factually" that payments by shippers to a railroad for constructing spur tracks for the use and benefit of the shippers were not taxable as income, although payments for operating deficits were so taxable.

The decisions of the Courts below are also in conflict with the opinion of Judge Learned Hand in *Bennet* v. *Helvering*, 137 F.2d 537 (2d Cir., 1943), which was decided only a few months after the *Detroit Edison* decision. In that case, although a taxpayer had never reported stock as income for tax purposes when it was received, the Second Circuit permitted the taxpayer to take a deduction for loss upon the stock, on

the reasoning that if property is subject to income tax, then it is subject to loss or depreciation whether or not ever actually declared as income. Since in the *Detroit Edison* case this Court had held that there was no basis for a depreciation allowance, Judge Opper said in the instant case, concurring in the decision of the Tax Court below (R. 33):

> "Basis for gain or loss and basis for depreciation being for all practical purposes identical * * * the reasoning of the *Bennet* case would mean that *Detroit Edison* must inferentially have decided that the contributions involved there had never been properly reportable as taxable income. In other words, if the *Bennet* result is right, the present conclusion must be wrong.
>
> "But since I think the theory of the *Bennet* case cannot be supported [footnote], I agree with this result."

2. The Decisions of the Courts Below Are in Direct Conflict With Thirty Years of Administrative Application

For thirty years, the Commissioner has uniformly applied the doctrine that funds paid as reimbursement for capital expenditures under circumstances which "cannot be distinguished factually" from this case are not includible as gross income, without regard to the direct benefits which may accrue from operation to the contributors who may be the only customers for service. See, e.g., *Midland Valley Railroad Co.* v. *Commissioner*, 19 B.T.A. 423 (1930), where the Commissioner conceded it was error to include payments by shippers for facilities to serve the parties making the payments in the computation of income subject to tax. As noted, in the *Detroit Edison* and *Brown Shoe* cases, the contributions were treated as non-taxable income. Indeed although *Detroit Edison* was

decided in 1943 and *Brown Shoe* in 1950, so far as is known never until the instant case has the Commissioner ever attempted to apply the language in those cases to income cases.

3. The Decisions of the Courts Below Are in Direct Conflict With Legislative Affirmation of Prior Interpretations Overruled by the Courts Below

In 1954, the Congress for the first time specifically provided in Section 118(a) of the Internal Revenue Code of 1954 that gross income subject to tax does not include contributions to the capital of a corporation. The detailed discussion of the bill in the House Committee Report, H.R. Rept. No. 1337, 83d Cong. 2d Sess. A38 (1954), states:

> "This section has no counterpart in the 1939 Code; however, the rule of this section, that contributions to the capital of a corporation are excluded from income, merely restates the existing law as developed through administration and court decisions. * * *"

To the same effect is the counterpart in the Senate Committee Report, Sen. Rept. No. 1662, 83d Cong., 2d Sess. 190 (1954). At that time, it must be noted, the Commissioner and the Courts below had not yet overruled thirty years of precedent, so that the cases which it is conceded "cannot be distinguished factually" retained their vigor as "existing law:"

4. The Decisions of the Courts Below Present an important Question in the Administration of the Federal Tax Laws and the Operation of a Substantial Number of Community Antenna Systems and Railroad, Gas, Electric Power, Telephone, and Water Companies

There are approximately 586 operating community antenna systems in the United States. A number of the earlier systems, including petitioner, have followed

the "contributions in aid of construction" theory in constructing their facilities, and consequently have cases pending before the Internal Revenue Service.

The effect of the decisions of the Courts below, however, will extend far beyond community antenna television systems to reach substantial numbers of railroads, gas companies, electric power companies, telephone companies, and water companies. The Court of Appeals, adopting the view of the Tax Court (R. 29), stated in the opinion below (App., p. 12a):

> "We are unable to discern any substantial factual distinctions between the initial payments made by the taxpayer's customers in the instant case and the payments made by the customers in Detroit Edison. * * *"

and has agreed with the Tax Court that the many cases now overruled involving these various facilities cannot be distinguished factually (R. 29; App., pp. 15a-16a).

Contributions in aid of the construction of capital facilities by prospective users is a necessary part of rules promulgated for the accounting systems of the various companies enumerated. See e.g., Federal Communications Commission, Uniform System of Accounts for Class A and Class B Telephone Companies, Section 31.2-20(b), 47 C.F.R., § 31.2-20(b); Interstate Commerce Commission, Uniform System of Accounts for Steam Roads, Section 2(c), "Cost," and 2(c)(1), "Donations from Individuals or Others," 49 C.F.R. §§ 10.10-2(c), 10.10-2(c)(1), and Account 734, "Donations and Grants," 49 C.F.R., § 10.734 (formerly 10.702½B); National Association of Railroad and Utilities Commissioners, Uniform System of Accounts for Electric Utilities, Gas Utilities, and

Water Utilities Class A and Class B, Account 265, "Contributions in Aid of Construction," and Instructions-Utility Plant Accounts, Instruction 3F.' The various companies concerned will be affected in a number of ways:

(1) Contributions heretofore not considered includable in gross income will now be taxed, presumably with retroactive effect, based upon the decisions in the instant cases.

(2) Pursuant to the various uniform systems of account, the companies will at the same time be denied a return on their properties from contributions because the sums received may not be included as a part of the rate base for rate making purposes.

(3) There is considerable question whether such contributions may be allowed as a basis for depreciation, under the decision of this Court in the *Detroit Edison* case if, as stated, there are no substantial factual distinctions (App., p. 12a).

(4) Many companies may be required to maintain a double set of accounting records, one for regulatory purposes and one for income tax purposes.

The decision of the Kansas Corporation Commission, In the Matter of the Investigation of the Kansas City Suburban Water Company, Inc., 22d Biennial Report (July 1, 1952—June 30, 1954), pp. 28, 37, is illustrative:

> "* * *[T]he Water Company transferred from its Account 241, Customers' Advances for Construction—Contingently Refundable, a total of $6,839.22 * * * representing certain contributions by customers for the construction [sic] of plant, which were no longer refundable under its contracts. Contrary to accepted practices the Company

credited this amount to Other Income, which amount should have been accounted for as Contributions in Aid of Construction as the Uniform System of Accounts now provides. The contention that no adjustment should be made because income tax has been paid on this amount is not logical for the reason that it was not income. The item should be deducted from the rate base and the Company will adjust its Account 265 to reflect such contributions."

CONCLUSION

For the foregoing reasons, it is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 12,255

TELESERVICE COMPANY OF WYOMING VALLEY,
Petitioner-Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

Argued November 8, 1957

Before MARIS, KALODNER and STALEY, *Circuit Judges*

OPINION OF THE COURT

(Filed March 24, 1958)

By KALODNER, *Circuit Judge*

Were "contributions" received by the taxpayer, a television signal transmission service, from its customers, "toward the total cost of constructing" its facilities, under a contract which simultaneously provided for such "contributions" and the further payment of a "monthly main-

tenance charge", includable as "gross income" under Section 22(a) of the Internal Revenue Code of 1939?[1]

That is the issue presented by this petition for review of the decision of the Tax Court[2] which answered it affirmatively, thereby making the "contributions" toward the cost of construction taxable as gross income. The Tax Court's decision was premised on its "Ultimate Finding" that the "contributions" to the taxpayer ". . . were not gifts or contributions to capital; they were part of the payment for services rendered or to be rendered by the petitioner [taxpayer] and are includable in petitioner's [taxpayer's] gross income."

It must immediately be noted that the "Ultimate Finding" of the Tax Court ". . . was in the nature of an ultimate finding of fact and since such finding is but a legal inference from other facts it is subject to review free of the restraining impact of the so-called 'clearly erroneous rule' applicable to ordinary findings of fact by the trial court . . ."[3]

The facts may be summarized as follows:

Teleservice Company of Wyoming Valley ("taxpayer") is a Pennsylvania corporation. It promoted, constructed

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[1] "Sec. 22. GROSS INCOME.

(a) *General Definition.*—'Gross Income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit or gains or profits and income derived from any source whatever. . . ." 26 U.S.C. 1952 ed., Sec. 22.

[2] 27 T.C. 722 (1957).

[3] Phillber Equipment Corporation v. Commissioner, 237 F.2d 129, 131 (3d Cir. 1956).

and now operates for profit a community antenna television system at Wilkes-Barre and Kingston, Pennsylvania.

The residents of Wilkes-Barre and Kingston were unable by conventional television roof-top or built-in antennas to receive television signals of an adequate visual quality due to the fact that the cities are located in valleys surrounded by hills which effectively screened or cut off television signals which would otherwise be available for reception by conventional methods. Therefore, in January, 1951, the taxpayer's incorporators determined that a company should be organized for the purpose of providing television signals to the residents of the Wilkes-Barre area through a community television system.

In 1951 no licenses for Ultra High Frequency (U.H.F.) television stations (to provide a local, conventional television service to the area) had then been issued, but there were indications that such licenses would be granted in the near future, and it was known that at least one company in Wilkes-Barre would make application for such license. This created a hazard to investment of money in the enterprise contemplated by the taxpayer. In addition, taxpayer's founders determined that the construction of a community antenna system was an unknown business with no adequate precedent to follow and without definite information available on past experience.

Two community antenna systems were investigated—one in Lansford, Pennsylvania, which was observed in operation, and another in Pottsville, Pennsylvania, which was in the process of being constructed. The taxpayer was the third company of its type in existence.

After a study of some six months, the taxpayer selected a suitable location for the interception of television signals on top of the mountain range surrounding Wilkes-Barre and Kingston. It found that it would be necessary to run a trunk line of coaxial cables from the location selected to

the edge of the populated area on the fringe of Wilkes Barre, a distance of about five miles, before any significant service could be offered. This "dead" trunk line was not found in the other systems studied; it would be costly, and taxpayer was not certain it would be a success. The Radio Corporation of America (R.C.A.) provided engineers to make a survey of the projected system, and furnished estimates of the cost of the equipment and materials that would be required. On the basis of the experience of the two other community antenna systems and the advice received from R.C.A. it was estimated that it would cost 96 cents per foot for the trunk line cable or feeder line cable to be installed and erected. This cost tended to be constant, regardless of the size of the system, since the only fixed cost was that of constructing the antenna tower atop the mountains which was relatively small—$1,500 to $3,000. It was calculated that the cost of constructing a system to serve Wilkes-Barre and Kingston would be as much as $250,000.

Before construction was begun or money paid into its treasury by its founders, the taxpayer decided that construction of the system would have to be financed essentially through contributions from prospective customers or subscribers since it would be too great a risk for it to undertake the entire investment and that, in any event, it would be impossible for it to realize a profit should it do so. It determined that whatever profit it might realize from the venture would come from monthly service charges.

Under the program formulated by the taxpayer contributors were divided into two classes—residential and commercial. The residential customers were to be required to make contributions of $145.00; the commercial customers $200.00. These varying scales were fixed by the taxpayer because, although service installation costs were the same with respect to both classes of customers, it believed that the commercial establishments could afford to contribute a greater amount than could a private individual. In fixing

the amount of the contributions to be made by customers the taxpayer took into consideration its estimated construction costs and amounts solicited by other community systems. In this connection taxpayer estimated that the contributions, if it obtained the number of customers anticipated, would just about balance the costs of construction of its entire system.

The taxpayer's program also provided that residential customers were to pay $4.00 monthly and commercial customers $6.00 monthly as a service or maintenance charge in addition to their initial contributions. The monthly charges were designed to cover the maintenance of the community system and included an element of profit to the taxpayer. The rates were not set by any regulatory commission.

The taxpayer's system was constructed in several distinct stages. The first step was the erection of a tower and intercepting antennas and the installation of a main trunk line cable, approximately five miles in length, to the first distribution area. The cost of this first stage, $24,138.49, was advanced by the taxpayer's incorporators.

On completion of this first step potential subscribers were solicited. When a sufficient number of applications for service had been received to indicate that further extension of the system would be feasible the taxpayer entered into contracts with subscribers and then proceeded with construction in the area in which they were located. Six months elapsed after completion of the initial construction before the first extension of the system was undertaken. Thereafter, the delay between extensions was substantially reduced.

Upon acceptance of an area for the extension of service, taxpayer entered into contracts with the subscribers. Taxpayer agreed "to furnish subscriber at the place of installation . . . a television signal transmission service". The subscriber, in turn, agreed (1) to contribute the

sum specified "toward the total cost of constructing a system for the transmission of a television signal" and (2) to pay "a monthly maintenance" charge which would entitle him to receive service. While a contribution was a prerequisite to eligibility to use of the system, it did not entitle the contributor to receive television signals. The contributor was required to make monthly payments, in advance, in order to receive the signals. Potential subscribers were advised that the contribution was in aid of construction of the facility for supplying the television signals, and had no bearing on the service, which would be charged as an extra item.

A contributor could not sell, assign, or transfer his eligibility to receive television signals, but he remained eligible to receive the signals without additional cost if he moved to another part of Wilkes-Barre or Kingston. However, the person who moved into the contributor's old home was required to make a contribution in order to become eligible to use the system.

The contract between taxpayer and its customers specified that it was subject to "General Provisions." The latter in turn provided, inter alia: (1) if the taxpayer by reason of its public utility contracts or governmental action found it ". . . either impossible or impractical . . . to furnish television transmission service under this contract . . ." it had the right to terminate the contract and in such event ". . . *all contributions, maintenance rates, and other moneys paid . . . by Subscriber [to it] shall be forfeited*"; (2) taxpayer could terminate its contract with the subscriber in the event of the latter's violation and that in such event ". . . Subscriber shall not be entitled to a refund of any kind . . ."; and (3) if taxpayer terminated the contract for its convenience ". . . Subscriber *shall be refunded a part of his contribution money*, as follows: A maximum of Sixty (60) Dollars less Ten (10) Dollars for each month this contract has been in effect . . ." (emphasis supplied).

No change was ever made in the $4.00 monthly charge for maintenance in the case of a residence, or in the $6.00 monthly charge in the case of a commercial establishment. Also, the $200.00 contribution required of commercial establishments was never changed. However, the amount required of residential subscribers was reduced to $89.00 on January 1, 1953; to $80.00 on June 1, 1954; to $30.00 in August, 1955, and no contributions have been required since 1956.

The greatest number of connections in operation at one time was about 900 and the least was about 200 to 300. In 1956 there were about 400 connections in operation. The decrease in connections resulted in 1952 when U.H.F. licenses were granted to local television stations in Wilkes-Barre and Scranton, Pennsylvania. The number of contributions also fell off sharply at that time.

During the period February 20, 1951, to January 31, 1952, the first tax year here involved, taxpayer received under contracts "contributions" totalling $27,601.98; during the same period construction costs of the system totalled $62,880.64.

During the period February 1, 1952, to January 31, 1953, the second tax year here involved, taxpayer received under contracts "contributions" totalling $88,544.79; during this period construction costs of the system totalled $70,620.78.

As reflected by the foregoing, the total cost of constructing the system amounted to $133,501.42 of which sum $116,146.77 was paid for by the "contributions" and the balance of $17,354.65 was financed with borrowed money. All of the funds received as "contributions" were applied to construction costs. Taxpayer's operating expenses were paid from sums collected from subscribers as monthly payments for maintenance and operation, under the terms of their contracts.

All initial payments received by the taxpayer were credited to an account maintained in its books and records called "Customer Contributions". Segregation of the funds paid as contributions was maintained on the books of the taxpayer, as against sums received from monthly maintenance charges. All funds were deposited in the taxpayer's general bank account from which were paid general operating expenses and the cost of all assets acquired. However, the taxpayer's accounting system segregated the costs of construction and the amounts received as contributions. The amounts received as contributions were never applied by the taxpayer to any of the expenses normally chargeable to operation. Only the monthly service charges were employed for such expenses.

Taxpayer in filing its income tax returns did not include the contributions from subscribers in its gross income. Further, it did not claim deductions upon its income tax returns for depreciation of the physical facilities of the community antenna television system but showed the accounting depreciation as a non-deductible item.

The Commissioner treated the contributions as gross income during the taxable years involved and determined a deficiency accordingly. In such determination he, however, allowed the taxpayer a deduction for depreciation of the physical assets of its system purchased with the contributions. The Commissioner's determination resulted in the tax deficiencies here in issue—$3,210.83 for the year ended January 31, 1952, and $13,013.09 for the year ended January 31, 1953.

Taxpayer unsuccessfully petitioned the Tax Court for redetermination of the deficiencies asserted by the Commissioner. It may be noted parenthetically that the Tax Court's decision was "Reviewed by the Court" and that one judge dissented.

Sketched in sweeping outline the contentions of the taxpayer and the Government may thus be stated:

Taxpayer urges that the contributions received from subscribers here were "in aid of capital construction" and thus did not constitute "income" under what it characterizes as the basic teaching of the "doctrine" of Edwards v. Cuba Railroad Co., 268 U.S. 628 (1925).

The Government asserts (1) the Internal Revenue Code of 1939 accords no tax exemption for "contributions in aid of capital construction"; (2) only payments which are made in the nature of gifts or capital contributions are excludable from gross income; (3) payments in aid of construction which are made in return for services rendered or to be rendered are not gifts or capital contributions and (4) the so-called "contributions" made by subscribers here actually constituted part of the price of the services to be rendered by the taxpayer. In support the Government cites Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943).

The parties agree, as did the Tax Court, that Edwards v. Cuba Railroad Co., supra, was followed by the Tax Court (and its predecessor Board of Tax Appeals) for some thirty years until the decision now under review.

The Tax Court in its opinion declared that it was compelled to the conclusion it reached under Detroit Edison Co. v. Commissioner, supra, and the doctrine of Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955) and General American Investors Co. v. Commissioner, 348 U.S. 434 (1955). It conceded, that apart from Edwards v. Cuba Railroad, supra, which it distinguished factually, it was unable to make similar distinction with respect to its own prior application of the Edwards decision in numerous cases. With respect to the latter it frankly stated (p. 729):

> "In spite of the sheer weight in number of those decisions, we feel bound to make an ultimate finding consistent with that of the *Detroit Edison* case, and what in our view appears to be a gradually but persistently

broadening concept of taxable income as exemplified by the *Glenshaw Glass Co.* and *Gen. Investors Co.* cases, *supra.*"

In view of the foregoing, since the precise issue here presented is of first impression on the appellate level, and, according to the taxpayer, is a test case affecting a substantial number of cases now pending before the Internal Revenue Service, we are constrained to relate in some detail the factual aspects of this controversy.

The taxpayer cites as critical and dispositive on the score of the issue as to whether the initial payments made by subscribers were "contributions in aid of capital construction", or, as the Government asserts, and the Tax Court found, "part of the payment for services rendered or to be rendered" the following elements:

The communal aspects of the enterprise, and its pioneer, highly expensive and hazardous nature; subscribers' initial payments were intended to be, and were, expended solely for capital construction; the advice given to subscribers on their solicitation that it was the considered and declared intention of the taxpayer's incorporators to finance capital construction through "contributions"; the latter were denominated as "contributions" by the contracts; total "contributions" at all times were less than construction costs; they were segregated on the taxpayer's books and treated in its tax returns as such; the amount of the contributions was reduced from time to time so as not to exceed the costs of construction; subscribers were required by their contracts to make monthly service payments in order to receive service and profits, if there were any, were only realizable from the monthly service payments; and finally, the capital facilities had no salvage value.

The Government cites these factual elements:

The initial payments were made pursuant to a contract under which taxpayer legally obligated itself to per-

form services in exchange; only those persons who made the initial payments were eligible to receive service upon further payment of monthly service charges; the payments in question were not made for the benefit of the public or the community at large, but for the sole and exclusive benefit of the customers making the payment—that benefit consisting of agreed services to be rendered by the taxpayer; the customer could not sell, assign, or transfer his eligibility to service; although a customer who made the initial payment remained eligible to receive service even though he moved to a different part of the community, the person who moved into his old home was required to m... an initial payment of his own in order to become eligible to receive the taxpayer's service; and, commercial establishments were required to make a higher initial payment than residential customers solely because it was thought they could pay the higher amount.

In considering the issue presented here we are guided by these well-settled principles: "Taxation is an intensely practical matter, and, it deals with realities not semblances; with substance and not form . . .",[4] and, "It must ever be kept in mind 'that the substance of the transactions will prevail over form' ".[5]

Upon consideration of the record and the contentions of the parties as to the ultimate finding of fact to be made from the undisputed basic facts we are of the opinion that the Tax Court's ultimate finding that the initial payments made by the taxpayer's customers ". . . were not gifts or contributions to capital", but ". . . were part of the payment for services rendered or to be rendered" by the taxpayer, was amply sustained by the record and that the Tax Court correctly ruled the initial payments to be includable in the taxpayer's gross income under Section 22(a) of the Internal Revenue Code of 1939.

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[4] Thompson v. Commissioner, 205 F.2d 73, 78 (3rd Cir. 1953).

[5] Urquhart v. Commissioner, 215 F.2d 17, 19 (3rd Cir. 1954).

Detroit Edison Co. v. Commissioner, supra, is an illuminating guide to our determination, although it is true, as the taxpayer urges, that the Supreme Court did not, nor was it required to, there decide the precise issue here presented.

In Detroit Edison the taxpayer claimed depreciation on certain extensions of its lines paid for by prospective customers as a prerequisite to obtaining service and treated by the taxpayer as contributions to capital. The payments made by the customers never exceeded and sometimes fell short of the actual cost of the facilities. They were not included in taxpayer's gross income in its tax returns.

In holding that the Detroit Edison Company did not acquire a substituted basis for depreciation by virtue of its receipt of estimated construction costs from applicants for its services the Supreme Court said, (pp. 102, 103):

> "The Company, however, seeks to avoid this result by the contention that what it has obtained are gifts to it or contributions to its capital of the property paid for by the customer, and that therefore by the provisions of § 113(a)(2) and (8)(B) it takes the basis of the donor or transferor. *It is enough to say that it overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company. The transactions neither in form nor in substance bore such a semblance.*
>
> "*The payments were to the customer the price of the service . . .*" (emphasis supplied)

We are unable to discern any substantial factual distinction between the initial payments made by the taxpayer's customers in the instant case and the payments made by the customers in Detroit Edison. In each case the payments were made as a prerequisite to obtaining direct personal service via the construction of facilities

which would provide such service; in each instance the payments were not for a community or public benefit, as in Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950) and in Commissioner v. McKay Products Corp., 178 F.2d 639 (3rd Cir. 1949), where the payments made were to the taxpayer by a community group to promote communal interests, and were for that reason held to be "contributions to capital" meriting depreciation allowance under applicable revenue laws.

In both the Brown Shoe and the McKay Products cases it was stressed that the payments were not made by "customers" nor as "payments for service" to them.

In Brown Shoe the Supreme Court emphasized these factors, stating (p. 591):

> "Because in the *Detroit Edison* case 'The payments were to the customer the price of the service,' the Court concluded that 'it overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company.' Since in this case there are neither customers nor payments for service, we may infer a different purpose in the transactions between petitioner and the community groups. The contributions to petitioner were provided by citizens of the respective communities *who neither sought nor could have anticipated any direct service or recompense whatever, their only expectation being that such contributions might prove advantageous to the community at large.* Under these circumstances the transfers manifested a definite purpose to enlarge the working capital of the company." (emphasis supplied)

In McKay Products, Judge Goodrich, speaking for this Court said (p. 643):

> "We think that what is significant is that the Detroit Edison Co. *was in the business of selling electric power to the very persons whose payments it sought to de-*

> *preciate*, and that it was Detroit Edison's policy to deliver power to outlying areas *only* if the consumer bore the cost of the line extension. The matter is really summed up in the Court's statement that *payments were the price of the service.*" (emphasis supplied)

Our determination that the initial payments in the instant case were "the price of the service" received by taxpayer's customers is buttressed by these additional factors, absent in Detroit Edison: (1) while a customer who made the initial payment remained eligible to receive taxpayer's service even though he moved to a different part of the community the person who moved into his old home was required to make an initial payment of his own in order to become eligible to receive service; (2) the contract between the taxpayer and its customers provided for "forfeiture" of the latter's initial payments in the event of any default on their part and for a "refund" of such payments, according to a fixed schedule, in the event the "taxpayer terminated the contract for its convenience" and (3) commercial establishments were required to make a higher initial payment than residential customers solely because it was deemed by the taxpayer that they could afford the higher amount.

The requirement that one who moved into a customer's old home must make an initial payment of his own in order to receive service scarcely squares with the taxpayer's contention that all initial payments by subscribers were "in aid of capital construction" and the contractual provisions for "refunds" of initial payments on certain contingencies are certainly at odds with the taxpayer's concept of such payments as "contributions".

The variation in the scale of initial payments required of individual and commercial customers based on the "ability to pay" concept certainly lends itself more to a "price for service" finding than a "contribution" theory.

Analysis of the substance rather than the semblance of the relationship existing between the taxpayer and its customers in the light of the principle that "taxation is an intensely practical matter" inescapably discloses that the relationship was that of seller-customer.

The communal aspect of the enterprise, urged by the taxpayer, are entirely lacking in significance. The initial payment made by a customer was the admission price which he paid for his individual enjoyment of the taxpayer's facilities and in no sense could it be regarded as a contribution to community participation. Only he who bought a ticket could "go for the ride". The pioneer and hazardous nature of the enterprise and the circumstance that the capital facilities had no salvage value, heavily stressed by the taxpayer, are of no critical value with respect to the issue here involved.

The taxpayer's reliance on Edwards v. Cuba Railroad Co., supra, is to state it bluntly, misplaced. The facts in that case are clearly distinguishable. There as the Supreme Court stated (p. 633) "The subsidy payments taxed were not made for services rendered or to be rendered." Furthermore, as observed by Chief Judge Biggs, speaking for this Court in Commissioner v. Glenshaw Glass Co., 211 F.2d 928, 931 (1954),* the Supreme Court in Detroit Edison ". . . indicated some halt in the doctrine expressed in Edwards v. Cuba R. Co."

As to Liberty Light & Power Co., 4 B.T.A. 155 (1926), Great Northern Railway Co., 8 B.T.A. 225 (1927) aff'd 40 F.2d 327 (8th Cir. 1930), cert. den. 282 U.S. 855 and cases which followed the rule they enunciated, we can only say we are not in accord. We agree with the Tax Court that these cases cannot be distinguished factually.

* Reversed on other grounds, Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), rehearing denied 349 U.S. 925.

The Supreme Court, in Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), Gen. Investors Co. v. Commissioner, 348 U.S. 434 (1955), Commissioner v. LoBue, 351 U.S. 243 (1956) has, as it stated in the latter case (p. 246) ". . . repeatedly held that in defining 'gross income' as broadly as it did in § 22(a) Congress intended to 'tax all gains except those specifically exempted' ". In Robertson v. United States, 343 U.S. 711, 714 (1952) it was specifically held that "Where the payment is in return for service rendered . . ." such payment is gross income under § 22(a).

There remains but this to be said. Taxpayer urges that Congress has now specifically recognized, by the enactment of Section 118(a) of the Internal Revenue Code of 1954, that gross income does not include any contribution to the capital of a company. Our agreement with the Tax Court's ultimate finding that the initial payments here were "part of the payment for services rendered or to be rendered" and not as capital contributions makes unnecessary any discussion of that contention. However, we must point out that the Committee Reports[7] accompanying Sections 118 and 362[8] of the 1954 Code (also cited by taxpayer) make it clear these provisions are not applicable to contributions or other payments by persons who are direct beneficiaries of the service rendered by the recipient corporation.

For the reasons stated the decision of the Tax Court will be affirmed.[9]

[7] H.R. No. 1337, 83d Cong., 2d Sess. 17 (1954); Sen. Rep. No. 1662, 83d Cong., 2d Sess. 18 (1954).

[8] Sen. Rep. No. 1662, 83d Cong., 2d Sess. 271-272 (1954).

[9] It merits observation that in his excellent Note—Contributions to Capital by Non-shareholders, 3 Tax L. Rev. 568, 573 (1948), Joseph O'Meara, Jr., then lecturer on Federal Taxation, University of Cincinnati, College of Law, concluded with this statement:

> "*Detroit Edison* accordingly appears to foreshadow a contraction of the area in which *Cuba Railroad* will be followed in the future; it suggests that a payment will not be considered a contribution to capital if exacted from a prospective customer as a prerequisite to doing business with him."

APPENDIX B

ON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

Present: MARIS, KALODNER and STALEY, Circuit Judges.

Judgment

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

March 24, 1958

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1957

No. 983

TELESERVICE COMPANY OF WYOMING VALLEY, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

On Petition for Writ of Certiorari to the United States Court of Appeals for the Third Circuit

REPLY TO RESPONDENT'S BRIEF IN OPPOSITION

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INTRODUCTORY STATEMENT

The legal issue between the parties has been fairly joined—whether funds paid as reimbursement for the construction of capital facilities constitute taxable income, because operation of the facilities makes possible the furnishing of services to contributors who pay monthly charges. As heretofore noted (Pet. 3), the facts of the case are not in dispute. However, petitioner believes that respondent's abbreviated statement

(Res. Br. 3-6) fails to state some of the facts of record, set forth in the opinion of the Court below, which are material to the consideration of the question presented. The facts believed essential to a proper resolution of the issue herein, including those which are set forth in respondent's statement, are summarized from the Circuit Court's opinion (Pet. 1a-16a) in petitioner's statement of the case (Pet. 3-7).

The paragraphs of the reply are numbered to correspond to those of the brief for the respondent in opposition. Points heretofore urged in the petition for writ of certiorari not here restated are of course preserved.

REPLY TO RESPONDENT'S ARGUMENT

1. There is no dispute between petitioner and respondent that this Court has repeatedly held that in adopting the broad definition of income of Section 22(a) of the Internal Revenue Code of 1939, the Congress intended to tax all *gains* except those specifically exempt. *Commissioner* v. *Lo Bue*, 351 U.S. 243 (1956); *Commissioner* v. *Glenshaw Glass Co.*, 346 U.S. 426 (1955); *Robertson* v. *United States*, 343 U.S. 711 (1952). The thrust of petitioner's argument in this case, however, is that this Court in so holding has never equated *gains* with *capital*, the effective result of the decision here complained of. Indeed, in the *Glenshaw Glass* case cited by respondent, this Court specifically observed that the definition of income in *Eisner* v. *Macomber*, 252 U.S. 189, 207 (1920) as "the gain derived from capital, from labor, or from both combined" served a useful purpose in the context of *distinguishing gain from capital*, the very distinction urged here by petitioner as determinative.

In the companion case to *Glenshaw Glass* decided the same day, *General American Investors Company* v. *Commissioner*, 348 U.S. 434, 436 (1955), the Court made reference to *Texas & Pacific R. Co.* v. *United States*, 286 U.S. 285 (1932), which in its context of capital contributions illustrates that this Court has not intended to dilute the basic distinction made in that case between contributions in aid of *capital* construction and income payments for *operation* of the facility (see Pet. 7-9).

The Circuit Court decisions cited by respondent (Res. Br. 7) flow from this same distinction. In *Lykes Bros. S. S. Co.* v. *Commissioner*, 126 F. 2d 725 (5th Cir., 1942), the payments in question were made to a shipping company for carrying the United States mails, and were thus income from operation, disassociated from a separate contractual obligation to spend a stated sum within the succeeding ten years on building new ships or reconditioning old ones. As the Board of Tax Appeals there said below, 42 B.T.A. 1395, 1404 (1940):

> "An important fact in this case is that the mail payment income was directly dependent upon operations. If petitioner operated its vessels and carried ocean mails it was to be compensated therefor, based upon mileage and the class of vessel operated. The income was not, as in *Cuba Railroad Co.*, dependent on construction * * *."

In *Baboquivari Cattle Co.* v. *Commissioner*, 135 F. 2d 114 (9th Cir., 1943), the payments in question were made to farmers for compliance with conditions in respect of the *use* of his land, and were thus also income for operation. In *United States* v. *Maryland Jockey Club*, 210 F. 2d 367 (4th Cir., 1954), cert. den. 347 U.S. 1014 (1954) the payments in question were deducted

from gross amounts taken in from pari-mutuel betting at a race track, under State law which required that they be kept in a special fund for improvements, and thus again were income received and collected as a result of operation.

Application of the test is illustrated in the opinion of the late Chief Judge Parker in the precursor of the cases cited, *Helvering* v. *Claiborne-Annapolis Ferry Co. of Annapolis, Md.*, 93 F. 2d 875, 876 (4th Cir., 1938): "Taxpayer's capital was invested in wharves and ferryboats; and the payment by the state was intended, not to reimburse taxpayer for expenditures it had made in their purchase or equipment, but to compensate it in part for their operation."

The distinction between funds for capital construction and income from operation, based upon the nature of the sums in the hands of the taxpayer, and not the motives of or benefits to the contributors, is precisely the touchstone here urged by petitioner as the basic teaching of *Edwards* v. *Cuba Railroad Co.*, 268 U.S. 628 (1925), which is controlling in this case. The fundamental fact of this case is that petitioner here, as in *Cuba Railroad*, first constructed its capital facilities and then received contributions therefor from its donors, so that the funds could not go elsewhere than as reimbursement for capital expenditures. The fundamental error of the Court below consists in failing to recognize that here, as in *Cuba Railroad*, the receipt of benefits from operation of the facility is completely without significance in testing whether the funds are gain or capital.

2. For the reasons stated herein and in the petition for writ of certiorari, the decision of the

Court below is in conflict, inter alia, with *Edwards* v. *Cuba Railroad Co.*, 268 U.S. 628 (1925), and with the interpretation of that case in *Texas & Pacific Ry. Co.* v. *United States*, 286 U.S. 285, 289-290 (1932), and other cases cited (Pet. 8). The statement of this Court in *Cuba Railroad*, "The subsidy payments taxed were not made for services rendered or to be rendered," 268 U.S. at 633, was in the nature of an ultimate finding based upon facts in that case which in all *essential* particulars—the reimbursement of a corporation for capital expenditures, by a donor which anticipated receiving direct benefits from the operation of the facility—are on all fours with the instant case.

In stating (Res. Br. 9) that the decision below is not in discord with *Bennet* v. *Helvering*, 137 F. 2d 537 (2d Cir., 1943), respondent apparently disavows the concurring opinion in his favor in the Tax Court below by Judge Opper, who expressly stated, "In other words, if the *Bennet* result is right, the present conclusion must be wrong." (R. 33). Judge Opper was, however, correct in recognizing a conflict in the underlying basis for the results of the *Bennet* decision and the opinion of the Tax Court below—under the reasoning of the *Bennet* case, the holding in *Detroit Edison Co. v. Commissioner*, 319 U.S. 98 (1943), that the contributions were not deductible as basis for depreciation required that they also be held not properly reportable as income.

The Tax Court decisions cited by petitioner as following the *Cuba Railroad* doctrine (Pet. 15a) do not merely "appear inconsistent" (Res. Br. 9) with the decisions of the Courts below, they are in direct conflict with those cases, as both Courts below acknowledged (Pet. 15a). Whether or not the Tax Court is

at liberty to reconsider its previous position, after thirty years of judicial, legislative, and administrative acquiescence, it should not be permitted to do so, in the absence of a direct compelling mandate from a higher authority, without full judicial review of the basis for its reversal of precedent. Further judicial review by this Court would appear to be particularly appropriate in this case, where the ratio decidendi is an opinion of this Court (*Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98 (1943), which is admittedly no direct precedent but only "an illuminating guide" (Pet. 12a).

Respondent's brief states, "The decision of the Court of Claims (*Texas & P. Ry. Co.* v. *United States*, 52 F. 2d 1040 [(Ct. Cl., 1931), aff'd without discussion of this point, 286 U.S. 285 (1932)]) upon which taxpayer also relies, follows the early Tax Court decisions which have since been rejected." (Res. Br. 10). They have been rejected, however, only by the Tax Court in this case; they have never been rejected by the Court of Claims. The decision of the Court below, therefore, continues to be in direct conflict with the decision of the Court of Claims.

The "Commissioner's acquiescence in these early Tax Court decisions which both the Tax Court and the court below have now repudiated as unsound in the light of intervening decisions of this Court," (Res. Br. 10), it may be observed, was a uniform acquiescence of thirty years, continuing until the instant case, although the bases for its present repudiation is one case decided back in 1943, *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98 (1943), and another decided in 1950, *Brown Shoe Co.* v. *Commissioner*, 339 U.S. 583 (1950).

3. Petitioner relies upon Section 118(a) of the Internal Revenue Code of 1954 as a restatement of existing law affirming the non-inclusion of contributions to the capital of a corporation in income taxation. The law existing in 1954 which defined what constitutes contributions to capital was thirty years of decided cases, which concededly "cannot be distinguished factually" (Pet. 15a) from the instant case and which have now been overruled.

4. Petitioner asserts not only that this case presents an important problem because of accounting requirements for regulated utilities (cf. Res. Br. 10-11 with Pet. 15-16), but also that this case will directly affect the various companies enumerated in the petition in a number of other ways, as set forth in the petition:

(1) Since preceding cases "cannot be distinguished factually" (Pet 15a), the companies enumerated as well as petitioner will be required to pay income taxes upon contributions heretofore considered not includable in gross income, presumably with retroactive effect.

(2) At the same time, the companies will not be permitted to include the sums received in their rate base for rate-making purposes under existing uniform systems of account.

(3) There is considerable question whether such contributions may be allowed as a basis for depreciation under the decision of this Court in the *Detroit Edison* case if, as stated (Pet. 12a), there are no substantial factual distinctions.

CONCLUSION

For the foregoing reasons, in addition to those heretofore urged in the petition for writ of certiorari herein, it is respectfully submitted that said petition for writ of certiorari should be granted.

Respectfully submitted,

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No. 983

In the Supreme Court of the United States

October Term, 1957

TELESERVICE COMPANY OF WYOMING VALLEY,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

---

BRIEF FOR THE RESPONDENT IN OPPOSITION

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court are reported at 27 T.C. 722. The opinion of the Court of Appeals for the Third Circuit (Pet. 1a-16a) is not yet officially reported.

JURISDICTION

The judgment of the Court of Appeals was entered March 24, 1958 (Pet. 17a). The petition for a writ of certiorari was filed May 6, 1958. The jur-

isdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

The taxpayer, a corporation, entered into contracts under which it obligated itself to furnish services to customers in consideration of a price payable in advance and consisting of an initial payment (called a "contribution" toward the cost of the facilities necessary to furnish the services) and subsequent monthly payments (called "maintenance" charges).

The question is whether the initial payments received by the taxpayer under the contracts were part of the price of the services, and consequently includable in taxpayer's gross income under Section 22(a) of the Internal Revenue Code of 1939.

STATUTE INVOLVED

Internal Revenue Code of 1939:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * * *

(3) [as amended by Sec. 111(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Gifts, bequests, devises, and inheritances.*—The value of property acquired by gift, bequest, devise, or inheritance. * * *

* * * *

(26 U.S.C. 22.)

STATEMENT

The taxpayer, a corporation, constructed and operates for profit a community antenna television system at Wilkes-Barre and Kingston, Pennsylvania. It was organized to provide television signals to residents of the area through a community antenna system because television reception from stations in other cities was inadequate due to the mountainous terrain of the locality. (Pet. 2a-3a.) The cost of construction of a complete system was calculated to be as much as $250,000, and it was decided that construction would have to be financed principally through contributions from prospective customers or subscribers (Pet. 3a-4a). Contributors were divided into two classes—residential and commercial. The residential customers were to be required to make contributions of $145; the commercial customers $200. These varying scales were fixed by the taxpayer because, although service installation costs were the same with respect to both classes of customers, it believed that the com-

mercial establishments could afford to contribute a greater amount than could a private individual. Taxpayer estimated that the contributions, if it obtained the number of customers anticipated, would just about balance the costs of construction of its entire system. (Pet. 4a-5a.)

The taxpayer's program also provided that residential customers were to pay $4 monthly and commercial customers $6 monthly as a service or maintenance charge in addition to their initial contributions. The monthly charges were designed to cover the maintenance of the community system and included an element of profit to the taxpayer. The rates were not set by any regulatory commission. (Pet. 5a.)

The taxpayer's system was constructed in several distinct stages. The cost of the first stage, $24,138.49, was advanced by the taxpayer's incorporators. On completion of this first step potential subscribers were solicited. (Pet. 5a.)

Taxpayer entered into contracts with the subscribers whereby it agreed "to furnish [each] subscriber at the place of installation * * * a television signal transmission service." The subscribers, in turn, agreed (1) to contribute the sum specified "toward the total cost of constructing a system for the transmission of a television signal" and (2) to pay "a monthly maintenance" charge which would entitle them to receive service. While a contribution was a prerequisite to eligibility to use of the system, it did not entitle the contributor to receive television signals. The contributor was required to make monthly payments, in advance, in order to receive the signals. (Pet. 5a-6a.)

A contributor could not sell, assign, or transfer his eligibility to receive television signals, but he remained eligible to receive the signals without additional cost if he moved to another part of Wilkes-Barre or Kingston. However, the person who moved into the contributor's old home was required to make a contribution in order to become eligible to use the system. (Pet. 6a.)

The contract between taxpayer and its customers was subject to certain "General Provisions" which provided, *inter alia:* (1) if taxpayer from certain causes found it either impossible or impractical to furnish television transmission service it could terminate the contract, in which event all contributions, maintenance rates, and other monies paid by the subscriber were to be forfeited; (2) taxpayer could terminate the contract upon subscriber's default without any obligation to make a refund; and (3) if taxpayer terminated the contract for its convenience the subscriber was to be refunded a part of his contribution, based upon the number of months the contract had been in effect. (Pet. 6a.)

The contribution required of a commercial establishment has never changed. The amount required of residential subscribers was reduced in 1953, 1954 and 1955, and no contributions have been required of them since 1956. Monthly services charges of $4 for a residence and $6 for each commercial establishment have remained unchanged. Antenna connections fluctuated between a high of 900 and a low of 200 or 300. (Pet. 7a.)

During the two tax years (fiscal years 1952 and

1953) taxpayer received total "contributions" of $116,146.77 and expended a total of $133,501.42 towards construction, the balance being financed with borrowed money (Pet. 7a). All funds were deposited in the taxpayer's general bank account, from which were paid general operating expenses and the cost of all assets acquired. However, the taxpayer's accounting system segregated the initial payments, which were credited to an account called "Customer Contributions," from the monthly maintenance charges. The so-called contributions were not applied to any of the expenses normally chargeable to operation, only the monthly service charges being utilized for such expenses. (Pet. 8a.)

The taxpayer in its returns did not include the initial payments (contributions) received from its customers in its gross income. The Commissioner treated the initial as well as the subsequent payments as gross income, and determined deficiencies accordingly. In this determination he allowed the taxpayer a deduction for depreciation of the physical assets of its system purchased with the contributions. The Commissioner's determination was sustained by the Tax Court in a reviewed opinion, one judge dissenting. (Pet. 8a.) The Court of Appeals unanimously affirmed (Pet. 1a-16a).

ARGUMENT

1. The decision below, affirming that of the Tax Court, is correct. This Court has repeatedly held that in adopting the broad definition of gross income contained in Section 22(a) of the Internal Revenue Code

of 1939, *supra*, p. 2, Congress intended to tax all gains except those specifically exempted; and that amounts received in return for services, however labeled, are includable in taxable income. *Commissioner* v. *LoBue*, 351 U.S. 243; *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426; *Robertson* v. *United States*, 343 U.S. 711. In harmony with these basic principles the courts in a variety of settings have held that payments for services constitute taxable income notwithstanding that the recipient allocates the payments to capital expenditures. *Lykes Bros. S. S. Co.* v. *Commissioner*, 126 F. 2d 725 (C.A. 5); *Baboquivari Cattle Co.*, v. *Commissioner*, 135 F. 2d 114 (C.A. 9); *United States* v. *Maryland Jockey Club*, 210 F. 2d 367 (C.A. 4), certiorari denied, 347 U.S. 1014.

Both courts below found that the initial payments which taxpayer received from applicants for its television antenna service—and which it characterizes as "contributions" to its capital [1]—represented advance payment of part of the price of services to be rendered, not tax-exempt gifts or contributions to taxpayer corporation or to its stockholders. Their concurrent finding is unquestionably supported by the record.

It is undisputed that the payments were made pursuant to a contract under which taxpayer legally

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[1] The initial payments were recorded on taxpayer's books as "Customer Contributions" (Pet. 8a). Subsequent monthly payments received by taxpayer from the applicants, called "maintenance" charges (Pet. 6a), concededly represent taxable income.

obligated itself to perform services in exchange; and that only those persons who made the initial payments were eligible to receive the service upon further payment of monthly charges. Those who did not make these payments could not receive the service. In reality, therefore, the initial payments were as much a part of the customers' payments for service as were the subsequent monthly charges. Like any other compensation received, the funds were deposited in taxpayer's general bank account, without restriction as to use. That the amount initially received by taxpayer from its customers was used to defray the cost of materials needed to furnish the agreed services manifestly does not render that portion of the price paid for the services any different for tax purposes than the subsequent portions of the price used to defray the cost of necessary labor; each portion represented a component part of the total contract price for the agreed services paid to taxpayer in advance by the customers, and the first instalment no less than the others was income to taxpayer within the meaning of Section 22(a).

2. The decision below is not in conflict with any decision of this Court or of any court of appeals. The instant case differs materially from *Edwards* v. *Cuba Railroad*, 268 U.S. 628, upon which taxpayer chiefly relies for conflict (Pet. 7); as both courts below pointed out, it is like those cases which have distinguished that case. In the *Cuba Railroad*, this Court was careful to note that (p. 633) "The subsidy payments taxed were not made for services rendered or to be rendered." And this Court subsequently distinguished that case from others where,

as here, so-called capital contributions were in substance advance payments for goods or services. See *Texas & Pacific Ry. Co.* v. *United States*, 286 U.S. 285, 289-290; *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, 102-103; *Brown Shoe Co.* v. *Commissioner*, 339 U.S. 583, 591. Thus in *Detroit Edison*, in distinguishing *Cuba Railroad* and holding that a utiiity did not acquire a substituted basis for depreciation by virtue of receipt of estimated construction costs from applicants for its services, this Court stated that (pp. 102-103) "it overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company", and that "The payments were to the customer the price of the service." Here, as in *Detroit Edison* and unlike *Cuba Railroad*, the amounts received represented advance payments for future services. In the words of the court below (Pet. 15a), "taxpayer's reliance upon *Edwards* v. *Cuba Railroad Co.*, *supra*, is to state it bluntly, misplaced. The facts in that case are clearly distinguishable."

Nor is the decision below in discord with *Bennet* v. *Helvering*, 137 F. 2d 537 (C.A. 2), the only court of appeals decision with which taxpayer asserts conflict. (Pet. 11.) Indeed, the issue there—whether a taxpayer who failed to report income received in the form of property was estopped to deduct its loss in a later year—was far removed from the one here presented.

To be sure, the Tax Court decisions upon which taxpayer relies (Pet. 11) appear inconsistent with that court's later decision in this case, as both the

Tax Court itself and the court below acknowledged (Pet. 15a). But the Tax Court was of course at liberty to reconsider its previous position (*Louisville Property Co.* v. *Commissioner*, 140 F. 2d 547, 549-550 (C.A. 6th), certiorari denied, 322 U.S. 755). The decision of the Court of Claims (*Texas & P. Ry. Co.* v. *United States*, 52 F. 2d 1040), upon which taxpayer also relies, follows the early Tax Court decisions which have since been rejected. As for the long "administrative application" to which taxpayer points (Pet. 12-13), it consists of the Commissioner's acquiescence in these early Tax Court decisions which both the Tax Court and the court below have now repudiated as unsound in the light of intervening decisions of this Court.

3. The taxpayer's reliance (Pet. 13) upon Section 118(a) of the Internal Revenue Code of 1954, which excludes from the gross income of a corporation contributions to its capital, begs the very point at issue by assuming—contrary to the concurrent finding of both courts below—that the amounts here in question represented contributions to capital rather than advance payments for services. Moreover, as the court below pointed out (Pet. 16a), the pertinent committee reports make it clear that this provision of the 1954 Code merely restated the existing law and does not apply to so-called contributions received in consideration for services. See H. Rep. No. 1337, 83d Cong., 2d Sess., p. 17; S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 271-272 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4042, 4621, 4909-4910).

4. The taxpayer asserts (Pet. 13-16) that this case presents an important issue because regulated util-

ities are required to account for receipts such as those in question as contributions to capital rather than as income. There is nothing in the record to indicate (nor is it claimed) that taxpayer is required by any act or regulatory commission to account for payments received from its customers as contributions to capital. Even assuming some utilities are required to do so, it is fundamental that the requirements of an act, such as the Interstate Commerce Act, the purpose of which is to regulate commerce or like activities, and the methods of accounting prescribed or permitted by the regulatory body charged with the duty of administering that act, are not determinative of tax liability under the Revenue Act. *Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552, 562; *Kansas City Southern Ry. Co.* v. *Commissioner*, 52 F. 2d 372, 378 (C.A. 8th), certiorari denied, 284 U.S. 676.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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MAY, 1958.

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